ABSTRACT

This paper consolidates the work of its predecessor, “International Framework for Liquidity Risk Measurement, Standards and Monitoring: Corporate Governance and Internal Controls”, by considering monitoring tools which are considered to be essential if risks,(and in particular liquidity risks which are attributed to a bank), are to be managed and measured effectively by its management. It also considers developments which have triggered the need for particular monitoring tools – not only in relation to liquidity risks, but also to the rise of conglomerates and consolidated undertakings. It highlights weaknesses in financial supervision – weaknesses which were revealed following the collapses of Barings and Lehman Brothers. As well as attempting to draw comparisons between the recommendations which were made by the Board of Banking Supervision (BoBS) following Barings’ collapse, and the application issues raised by the Basel Committee in its 2009 Consultative Document, *International Framework for Liquidity Risk Measurement, Standards and Monitoring,* it highlights the links and relevance between both recommendations.

In drawing attention to the significance of corporate governance, audit committees, and supervisory boards, the importance of effective communication between management at all levels, to ensure transmission and communication of timely, accurate and complete information, is also highlighted. Through a comparative analysis of two contrasting corporate governance systems, namely, Germany and the UK, it analyses and evaluates how the design of corporate governance systems could influence transparency, disclosure, as well as higher levels of monitoring and accountability.

Whilst highlighting the need for, and the growing importance of formal risk assessment models, the paper also emphasises the dangers inherent in formalism – as illustrated by a rules based approach to regulation. It will however, demonstrate that detailed rules could still operate within a system of principles based regulation – whilst enabling a consideration of the substance of the transactions which are involved. In addressing the issues raised by principles based regulation, the extent to which such issues can be resolved, to a large extent, depends on adequate compliance with Basel Core Principle 17 (for effective banking supervision) – and particularly on the implementation, design and compliance with “clear arrangements for delegating authority and responsibility.”

Key Words: liquidity; principles based regulation; risks; corporate governance; audit; creative compliance

Risk Monitoring Tools in Bank Regulation and Supervision – Developments Since the Collapse of Barings Plc.

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A. Introduction

The Basel Committee's recent focus is reflected through its goals of intensifying the "resilience of internationally active banks to liquidity stresses", as well as the intensification of international harmonisation of liquidity risk supervision. These efforts are aimed at consolidating recent work which culminated in the issue of the Principles for Sound Liquidity Risk Management and Supervision.

As part of measures aimed at facilitating "further consolidation and promotion of consistency in international liquidity risk supervision", and in response to the "inaccurate and ineffective management of liquidity risk" – such ineffective management being a prominent feature of the Financial Crisis, the Basel Committee has developed a minimum set of monitoring tools to be used in the "ongoing monitoring of the liquidity risk exposures of cross border institutions and in communicating these exposures amongst home and host supervisors."[2]

In considering the topics of discussion, the ensuing section of this paper (after the introductory section) will be dedicated to developments which have triggered the need for particular monitoring tools - both in response to global developments and with particular reference to the ever increasing prominence of liquidity risks. Section three will then consider why there is greater need for enhanced disclosure requirements, as well as the need for greater reliance on disclosure requirements. Furthermore, it highlights the role played by enhanced disclosure requirements in facilitating the monitoring of risks. Disclosure and transparency should be enhanced if the communication of liquidity risk exposures are to be effective.

The importance of effectively managing internal controls will constitute the focus of discussion under section four. This will be considered against the background of failures and weaknesses in banks' internal controls and management systems – as illustrated by the collapse of Barings. As well as highlighting the contribution of corporate governance to an effective system of internal controls, section five will consider the role played by corporate governance in aggravating the effects of systemic and liquidity risks.

Good corporate governance would "provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders."[3] The dual faceted aspects of corporate governance relate not only to the accountability of management to shareholders, but also to the supervision and monitoring of management performance. Good corporate governance should facilitate effective monitoring, effective management of internal controls and risks, effective disclosure and transparency.

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[2] See Consultative Document „International Framework for Liquidity Risk Measurement, Standards and Monitoring at page 2

[3] See Basel Committee on Banking Supervision "Enhancing Corporate Governance for Banking Organisations" February 2006 at page 4

Under section six, a comparison will then be undertaken between the application issues for standards and monitoring tools and the recommendations made by the Board of Banking Supervision following the collapse of Barings. Furthermore, section six considers the increased formalisation of procedures with risk assessment tools and the role played by the external auditor in implementing and utilising regulatory standards and monitoring tools. The need for such increased formalisation with risk monitoring tools will be analysed against problems attributed to the formalisation of regulatory standards. Furthermore, off site and on site systems of supervision will be analysed, not only in relation to the external auditor's involvement in the supervisory process, but also in relation to the suggestion that the use of formal risk assessment models will imply a need "to bring the line supervisors into direct contact , on site, with a wider range of management."

The role of audit committees as internal monitoring tools of corporate governance in the UK will then be analysed and compared with the two tier system of disclosure which exists in Germany.

The final section of the paper will consider principles based regulation – within the context of compliance and enforcement, and also within the context of monitoring. The theme "substance over form" draws attention to creative accounting practices and the need for greater emphasis on principles based regulation. Creative accounting and "window dressing" of figures in the financial statements are ever recurring issues arising from corporate collapses – as also highlighted by the recent crises which involved Lehman Brothers.

Whilst the danger of formalism lies in the exercise of "creative compliance",[4] inherent problems of anti formalism are considered to include the fact that:[5]

- Citizens have the right to know exactly what is prohibited in advance of behaviour rather than in retrospect
- Broad rules are imprecise and over inclusive
- Anti formalism could result in ineffective control - where it is impossible to implement

Principles based regulation (PBR) is more advantageous than a rules based approach – owing to the fact that off balance[6] sheet debt could result from the direct application of rules – without being able to consider the substance of the transaction and because the implemented standards or rules do not allow such consideration. As its secondary argument[7], this paper will seek to demonstrate that detailed rules could still operate within a system of principles based regulation – whilst enabling a consideration of the substance of the transactions which are involved.

Regulatory standards implemented by the Basel Committee in its recent document[8] provide for "jurisdiction-specific conditions" – for example, the percentage of potential run-off of

[4] Creative compliance being the use of rules to escape control without actually violating those rules
[5] V Beattie, S Fearnley and R Brandt *Behind Closed Doors: What Company Audit is Really About* (ICAEW) 2001 at page 11
[6] Off balance sheet items are obligations which are contingent liabilities of a company/bank – and which as a result, do not appear on its balance sheet. Formal distinction between on and off balance sheet items, even though sometimes detailed, depend to an extent on the degree of judgement which is exercised by management.
[7] The primary theme being the importance of successfully communicating results obtained from monitoring and measuring such risks, and the role of corporate governance in ensuring such effective communication.
[8] See Consultative Document, „International Framework for Liquidity Risk Measurement, Standards and Monitoring" at page 2

retail deposits which is partially dependent on the structure of a jurisdiction's deposit insurance scheme."[9] Furthermore, the Committee highlights that "in these cases, the parameters should be **transparent** and clearly outlined in the regulations of each jurisdiction."[10] It also adds that this would provide clarity both within the jurisdiction as well as across borders concerning the precise parameters that the banks are capturing in these metrics, and that there was need for public disclosures in respect of regulatory standards.[11]

The ever growing prominence and importance of liquidity in prudential supervision constitutes a vital reason which justifies the need for a prudential supervisory framework which does not merely (and excessively) rely on capital adequacy requirements within such a framework.

Paragraph 56 of the Basel Committee on Banking Supervision's Principles for Sound Liquidity Risk Management and Supervision states that:

"A bank should have a reliable management information system designed to provide the board of directors, senior management and other appropriate personnel with timely and forward-looking information on the liquidity position of the bank. The management information system should have the ability to calculate liquidity positions in all of the currencies in which the bank conducts business – both on a subsidiary/branch basis in all jurisdictions in which the bank is active and on an aggregate group basis. It should capture all sources of liquidity risk, including contingent risks and the related triggers and those arising from new activities, and have the ability to deliver more granular and time sensitive information during stress events. To effectively manage and monitor its net funding requirements, a bank should have the ability to calculate liquidity positions on an intraday basis, on a day-to-day basis for the shorter time horizons, and over a series of more distant time periods thereafter. The management information system should be used in day-to-day liquidity risk management to monitor compliance with the bank's established policies, procedures and limits."[12]

B. Developments Since the Collapse of Barings and Events Culminating in the Introduction of Present Tools for Liquidity Risk Measurements

In February 2008, the Basel Committee on Banking Supervision published a paper titled "Liquidity Risk Management and Supervisory Challenges", a paper which highlighted the fact that many banks had ignored the application of a number of basic principles of liquidity risk

[9] ibid

[10] ibid

[11] ibid

[12] Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at page 17 <http://www.bis.org/publ/bcbs144.htm> Furthermore, paragraph 57 highlights the importance of a consensus between senior management in relation to a set of reporting criteria aimed at facilitating liquidity risk monitoring. Such reporting criteria should specify ""the scope, manner and frequency of reporting for various recipients (such as the board, senior management, asset – liability committee) and the parties responsible for preparing the reports." "Reporting of risk measures should be done on a frequent basis (eg daily reporting for those responsible for managing liquidity risk, and at each board meeting during normal times, with reporting increasing in times of stress) and should compare current liquidity exposures to established limits to identify any emerging pressures and limit breaches. Breaches in liquidity risk limits should be reported and thresholds and reporting guidelines should be specified for escalation to higher levels of management, the board and supervisory authorities."

management during periods of abundant liquidity.[13] An extensive review of its 2000 "Sound Practices for Managing Liquidity in Banking Organisations" was also carried out by the Basel Committee as a means of addressing matters and issues arising from the financial markets and lessons from the Financial Crises.[14] In order to consolidate on the Basel Committee for Banking Supervision's *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, which should lead to improved management and supervision of liquidity risks of individual banks, supervisory bodies will be required " to develop tools and policies to address the pro cyclical behaviour of liquidity at the aggregate level".[15]

The Principles for Sound Liquidity Risk Management and Supervision of September 2008 are aimed at providing "consistent supervisory expectations" on principal elements such as "board and senior management oversight; the establishment of policies and risk tolerance; the use of liquidity risk management tools such as comprehensive cash flow forecasting, limits and liquidity scenario stress testing; and the maintenance of a sufficient cushion of high quality liquid assets to address contingent liquidity needs."[16]

The link between liquidity and systemic risks as illustrated in the ECB's Financial Stability Review, is attributed to the "destruction of specific knowledge[17] which banks have about their borrowers and the reduction of the common pool of liquidity."[18] The importance of the link between liquidity risks and systemic risks within the banking sector is highlighted by the consequences attributed to the reluctance of banks to retain liquidity - given the cost of holding liquidity.[19] The consequential shortfalls of liquidity as reflected by on and off balance sheet maturity mismatches accentuates the importance of the role assumed by central banks in the funding of bank balance sheets.[20]

The link between liquidity and systemic risks is also accentuated under paragraph 77 of the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008. Principle 8 states that:

"A bank should actively manage its intraday liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions and thus contribute to the smooth functioning of payment and settlement systems."

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[13] Principles for Sound Liquidity Risk Management and Supervision Sept 2008 <http://www.bis.org/publ/bcbs144.htm>

[14] ibid

[15] "The FSF proposes that the BCBS and CGFS develop a joint research effort to address funding and liquidity risk, starting in 2009. A key component of this research agenda is to define robust measures of funding and liquidity risk, which could assist assessments of liquidity risk by the private sector. Stress tests to gauge the probability and magnitude of a liquidity crisis in different market environments will be considered in this light." For further information on this, see Report of the Financial Stability Forum on Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk" http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

[16] See Bank for International Settlements, Consultative Document "International Framework for Liquidity Risk, Measurement Standards and Monitoring" at page 1

[17] Since specific knowledge which banks possess about their borrowers is considered to be a factor which determines the illiquidity of bank loans; see "The Concept of Systemic Risk" ECB Financial Stability Review December 2009 at page 137 <http://www.ecb.int/pub/fsr/shared/pdf/ivbfinancialstabilityreview200912en.pdf?05d3164914c6a14bb13522 2b5c3894fa>

[18] ibid; According to the Review, the reduction in the common pool of liquidity also has the potential to trigger the failure of banks and could consequently lead to a devaluation of illiquid bank assets and further aggravation of problems within the banking sector.

[19] Report of the Financial Stability Forum on "Addressing Pro cyclicality in the Financial System: Measuring and Funding Liquidity Risk" http://www.financialstabilityboard.org/publications/r_0904a.pdf at page 24

[20] ibid

Paragraph 77[21] elaborates on this by highlighting the reasons why "intraday liquidity management" constitutes an important component of a bank's "broader liquidity management strategy." It goes on to state that a bank's failure to manage intraday liquidity effectively could result in its inability to meet payment obligations as they fall due, - hence generating consequences, not only for its own liquidity position, but also that of other parties. It illustrates how this could occur in two ways, namely:

- "The fact that that counter parties may view the failure to settle payments when expected, as a sign of financial weakness – which in turn could result not only in payments to the bank being delayed or withheld, but also in further aggravation of liquidity pressures.

- It also could leave counterparties unexpectedly short of funds, impair those counterparties' ability to meet payment obligations, and disrupt the smooth functioning of payment and settlement systems. Given the interdependencies that exist among systems, a bank's failure to meet certain critical payments could lead to liquidity dislocations that cascade quickly across many systems and institutions. If risk controls are overwhelmed, these dislocations could alter many banks' intraday or overnight funding needs, including their demands for central bank credit, and potentially affect conditions in money markets. The delay of other less critical payments also might cause other institutions to postpone their own payments, cause many banks to face increased uncertainty about their overnight funding needs and potentially increase the impact of any operational outages."

The growing importance of formalisation within the bank regulatory framework is also attributed to the gaps which exist within a discretionary based system of bank supervision – as was revealed in the aftermath of Baring Plc's collapse. The recent crisis has also highlighted the need for formal risk assessment models – as demonstrated by the demise of Lehman Brothers where the failures of auditors to detect balance sheet irregularities (owing to creative accounting practices) was brought to light.

The formal framework for the measurement of capital adequacy at European Community level, as exemplified by the International Convergence of Capital Measurements and Capital Standards(Revised Framework), namely Basel 2, is to be commended, not only because of "the need for a consistent framework for the reporting and comparative analysis of bank capital positions, the demand of regulated institutions for transparency and equality in the application of regulatory standards", but also because of "the exigencies of the international convergence process – which requires the transparent and uniform implementation of harmonised rules by the regulators of every country."[22]

As part of measures aimed at consolidating and "promoting consistency in international liquidity risk supervision", and in response to the "inaccurate and ineffective management of liquidity risk" – as was prominently highlighted during the recent financial crisis, the Basel Committee has developed a "minimum set of monitoring tools to be used in the ongoing monitoring of the liquidity risk exposures of cross border institutions and in communicating these exposures amongst home and host supervisors."[23]

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[21] Principles for Sound Liquidity Risk Management and Supervision Sept 2008 at pages 20 and 21

[22] See C Hadjiemmanuil, *Banking Regulation and the Bank of England* Lloyds of London Press 1995 at pages 208-209

[23] See Bank for International Settlements, Consultative Document "International Framework for Liquidity Risk, Measurement Standards and Monitoring" at page 2

The Liquidity Coverage Ratio[24] and the Net Stable Funding Ratio[25] are two regulatory standards for liquidity risk which serve the purpose of attaining the objectives of "promoting short-term resiliency of the liquidity risk profile of institutions" (by ensuring that they have adequate high quality liquid resources to survive during periods of extreme stress which last for about one month) and "promoting resiliency over longer-term periods" (through the creation of additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis).[26]

In addition to the above-mentioned standards, the Basel Committee recommends that supervisors also implement designated monitoring tools on a consistent basis. Such monitoring tools, along with the standards, are intended to provide supervisors with information which should aid their assessment of liquidity risks attributed to a particular bank.[27] These monitoring tools include: Contractual Maturity Mismatch, Concentration of Funding, Available Unencumbered Assets and Market – related monitoring tools.[28]

C. Disclosure

As well as the need for greater focus on liquidity risk, there is also the need for greater reliance on disclosure requirements. This will be facilitated through an effective monitoring process whereby identified risks are effectively communicated across all levels of management.

Enhanced transparency does not only have the potential to "improve an understanding of the mechanism at play in structured finance", but also facilitate the identification of risks and ensure that risks are well controlled. [29] Risky loans which were "repackaged and sold to institutional investors" – some of whom did not fully comprehend the implications of the transactions they were engaged in (or about to be engaged in), and the inherent risks associated with those transactions, are considered to be contributory factors to the 2007/09 Financial Crisis.[30]

Regulators will also be able to gain greater access to vital information which is required for effective performance of their functions where duties which are imposed on third parties, such as external auditors (in relation to the disclosure of information which is necessary and required for the efficient performance of the regulators' activities), are complied with – as opposed to a right to report.

The relationship between supervisory authorities and the external auditors of a credit institution and the duties of these auditors was identified as an important lesson from the

[24] This ratio „identifies the amount of unencumbered, high quality liquid assets an institution holds that can be used to offset the net cash outflows it would encounter under an acute short-term stress scenario by supervisors." ibid at page 3

[25] This ratio measures "the amount of longer-term, stable sources of funding utilised by an institution relative to the liquidity profiles of the assets being funded and the potential for contingent calls on funding liquidity arising from off-balance sheet commitments and obligations." ibid

[26] ibid

[27] ibid at page 25

[28] ibid

[29] See speech by C McCreevy European Commissioner for Internal Market an Services at the European Parliament 11 Sept 2007 http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/07/520&format=HTML&aged=l&language=EN&guiLanguage=en

[30] ibid

BCCI case.[31] Because of auditors' access to financial undertakings' accounts and other essential documents and information, they assume a vital position in the overall supervisory process. An analysis of BCCI revealed that measures, additional to those already existing, needed to be taken to eliminate the opaqueness of financial structures and strengthen cooperation between all bodies or persons involved in the supervision of such complex financial structures.[32]

As a result, the Basel Committee for Banking Supervision issued "minimum standards" which lay down rules for effective consolidated supervision and cooperation between supervisory authorities. This was not only aimed at strengthening international co operation between prudential supervisors, but also to improve transparency of financial, and in particular, group structures.

D. The Importance of Effective Management of Internal Controls

"Banks identified as having control problems have been characterised by organisational structures in which responsibilities were not clearly defined: hence (1) No senior management monitored the performance of activities (carried out within the organisation) closely to observe unusual activities 2) No senior management had a comprehensive understanding of the activities and how profits were being generated."[33]

The collapse of Barings in 1995 which was attributed not only to lack of quality and employee deception, also brought the issue of internal controls and management systems to the fore.[34] Barings' collapse illustrated weaknesses in the bank regulator's supervisory regime - which included flaws within its evaluation of internal controls at banks, flaws inherent in the internal communication within levels of management of the bank regulator, and weaknesses in the way the bank regulator's existing rules were applied.[35]

The need for improved communication at all levels (and also between all levels) of management, as well as increased efficiency in the application and interpretation of rules, principles and procedures, will be considered particularly under the last-but-one section of this paper, under principles based regulation.

The Basel Committee categorised into five groups, types of control breakdowns which are characteristic of ailing banks and these are as follows:[36]

- Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank[37]

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[31] JF Mogg, ‚The Bank of England and the Development of Internal Control Systems' in R Kinsella (ed*) Internal Controls in Banking* (Oak Tree Press Dublin 1995) at page 31

[32] ibid at page 28

[33] See "Framework for Internal Control Systems in Banking Organisations", Basel Committee for Banking Supervision 1998 at page 27

[34] Whilst it is contended by some that the problems attributed to Barings focussed round the lack of controls, the system of internal controls which operated were also considered by the regulator at the time (the Bank of England) to be informal but effective. See Barings Bank and International Regulation Volume 1 (12 December 1006) at page xiii

[35] See Treasury Committee, Barings Bank and International Regulation Report No 1 1996 page xv

[36] See Framework for Internal Control Systems in Banking Organisations, Basel Committee for Banking Supervision 1998 at pages 6 and 7

[37] In order to evaluate the quality of internal controls, supervisors could adopt a number of approaches which include i) the evaluation of the work of the internal audit department of the bank (through a review of its working papers – including the methodology implemented in identifying, measuring, monitoring and controlling risks). ii) If supervisors are satisfied with the quality of the internal audit department's work, they could use the reports of internal auditors as a primary mechanism for the identification of control problems in the bank (or for

- Inadequate recognition and assessment of the risk of certain banking activities, whether on or off balance sheet
- The absence or failure of key control structures and activities such as segregation of duties, approvals, verifications, reconciliations and reviews of operating performance
- Inadequate communication of information between levels of management within the bank – particularly the communication of information to higher ranked officials (senior management)
- Inadequate or ineffective audit programmes and monitoring activities

E. The Contribution of Corporate Governance to an Effective System of Internal Controls

Various corporate collapses have resulted in changes to financial reporting, corporate governance and audit.[38] The emphasis on internal controls and risk management emerged from the realisation that due to change in the business environment, even effective safeguards may be insufficient to eliminate all possibilities of failure.[39]

Keasy and Wright define corporate governance as the "examination of the structures and processes associated with production, decision making, control and so on within an organisation."[40] The two aspects of governance are considered to be i) Supervision and monitoring of management performance (the enterprise aspect) and ii) ensuring accountability of management to shareholders and other stakeholders (the accountability aspect).[41]

The feedback effects of corporate governance into the liquidity and systemic risk mechanisms are illustrated thus:

"Poor corporate governance may contribute to bank failures, which could pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macro economic implications, such as contagion risk and impact on payments systems. Furthermore, poor corporate governance could result in markets losing confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn, trigger a bank run or liquidity crisis."[42]

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identifying areas of potential risk – areas which have not been recently reviewed by the auditors). iii)Further some supervisors may use a self-assessment process in which management reviews the internal controls on a business by business basis whilst iv)other supervisors may require periodic external audits of key areas (given that supervisor defines the scope). Supervisors may ultimately combine one or more of the techniques highlighted under (i) - (iv) with own on site reviews or examinations of internal controls. See ibid at pages 22 and 23

[38] House of Commons Select Committee on Treasury, Minutes of Evidence submitted by the Institute of Chartered Accountants in England and Wales as part of its inquiry into the arrangements for financial regulation of public limited companies at page 17

[39] ibid

[40] See K Keasy and M Wright, 'Issues in Corporate Accountability and Governance: An Editorial' Accounting and Business Research, 23 (91A) at page 291. OECD principles define corporate governance as involving " a set of relationships between a company's management, its board, its shareholders, and other stakeholders." See Preamble to OECD Principles of Corporate Governance "OECD Principles of Corporate Governance" 2004 at page 11 <http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

[41] V Beattie, S Fearnley and R Brandt *Behind Closed Doors: What Company Audit is Really About* (ICAEW) 2001 at page 26

[42] See Basel Committee on Banking Supervision "Enhancing Corporate Governance for Banking Organisations" February 2006 at page 4

As well as a robust system of internal controls (which incorporates internal and external audit functions), the implementation of i) corporate values, codes of conduct, standards of appropriate behaviour and the system used in ensuring compliance with these, ii) a clear allocation of responsibilities and decision making authorities, iii) the establishment of a system which would guarantee efficient interaction and collaboration between the board of directors, senior management and auditors, and iv) special monitoring of risk exposures where conflicts of interest are likely to be high, are considered to be crucial to ensuring that sound corporate governance operates within an organisation.[43]

Furthermore, sound corporate governance practices are considered to require " appropriate and effective legal, regulatory and institutional foundations."[44] Even though factors such as the system of business laws and accounting standards which prevail in respective jurisdictions are considered to be factors which operate beyond the scope of banking supervision, the inclusion of four important forms of oversight are considered sufficient not only in ensuring that appropriate checks and balances exist, but that an effective system of corporate governance can be achieved.[45] The types of oversight include:

"(1) oversight by the board of directors or supervisory board; (2) oversight by individuals not involved in the day-to-day running of the various business areas; (3) direct line supervision of different business areas; and (4) independent risk management, compliance and audit functions. In addition, it is important that key personnel are fit and proper for their jobs. "[46]

The contribution and the role assumed by senior management in ensuring that internal control systems are effectively managed, is reflected through the Principles for the Assessment of Internal Control Systems.[47] The importance of monitoring and the rectification of deficiencies within internal control systems is reflected under principles 10-12.[48] Principle 10 highlights the importance of monitoring on a frequent and ongoing basis whilst principles 11 and 12 draw attention to the importance of effective collaboration and communication between highly trained competent staff, the board of directors, audit committees and senior management.[49]

According to paragraph 84 of the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008, internal coordination across business lines is vital towards ensuring that effective controls over liquidity outflows are achieved.[50] In relation to examples of actions which supervisors could adopt as means of responding to banks with liquidity risk management weaknesses or excessive liquidity risk, that which "requires actions by the bank to strengthen its management of liquidity risk through improvements in internal policies, controls or reporting to senior management and the board" is considered to have the greatest

[43] Basel Committee for Banking Supervision, " Enhancing Corporate Governance for Banking Organisations" 1999 at page 4
[44] Basel Committee for Banking Supervision, " Enhancing Corporate Governance for Banking Organisations" 2006 at page 5
[45] ibid
[46] ibid
[47] See particularly Principles 1-3 which relate to management oversight and the control culture; ibid at pages 2 and 3
[48] ibid at page 4
[49] ibid at pages 4 and 5
[50] Paragraph 16, as well as other sections which address and relate to internal and risk controls in particular, are considered to have the greatest importance out of all the sections within the BCBS *Principles for Sound Liquidity Risk Management and Supervision* of September 2008

potential to address deficiencies in a bank's liquidity risk management process or liquidity position.[51]

As observed by the Basel Committee,[52] "most banks that have experienced losses from internal control problems did not effectively monitor their internal control systems. Often the systems did not have the necessary built-in ongoing monitoring processes and the separate evaluations performed were either not adequate or were not acted upon appropriately by management."[53] Furthermore it highlights that such failures to monitor adequately commence with a "failure to consider and react to day-to-day information provided to line management and other personnel indicating unusual activity – such as exceeded exposure limits, customer accounts in proprietary business activities or lack of current financial statements from borrowers."[54]

F. Comparative Analysis between Application Issues for Standards and Monitoring Tools and Recommendations made by the BoBS following the collapse of Barings.

Following the collapse of Barings, recommendations[55] which were made to the regulator[56] include:[57] The need for a review of the scope of returns which were submitted to the regulator, the need for preparation of internal guidelines for bank regulator's staff (during reviews of solo consolidation) - in respect of procedures to be followed, the need for a review of Memorandums of Understanding (MoUs) between the bank regulator and other regulators involved in financial supervision.

It was also recommended that the bank regulator review the number and skills of staff it considered was necessary for on site supervision. Further proposals extended to the regulator include an extension of its involvement in international coordination where possible – by signing MOUs and involving non banking regulators, as well as its initiative of meeting the internal audit departments of banks.[58]

As well as the extension of the scope of reporting accountants' reports[59] – which was to be extended beyond banks and outside the national jurisdiction, the bank regulator was required to periodically require authorised institutions to extend reports commissioned into systems and controls to include the preparation and inputting of data in major overseas locations. The bank regulator was also required to extend its guidance to managers in relation to large exposures and to ensure that it understood the principal elements of the management and control structures of those banking groups where it was responsible for consolidated supervision.

Whilst the above recommendations focussed on the scope of application (whether the application of particular procedures were to be extended to group and/or entity level and to

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[51] See paragraph 142 of BCBS Principles for Sound Liquidity Risk Management and Supervision of September 2008

[52] See "Monitoring Activities and Correcting Deficiencies" Framework for Internal Controls in Banking Organisations, Basel Committee on Banking Supervision 1998 at page 30

[53] See ibid at paragraph 10

[54] See ibid at paragraph 11

[55] Recommendations issued by the Board of Banking Supervision

[56] The bank regulator during this period was the Bank of England

[57] See Treasury Committee Barings Bank and International Regulation Report No 1 (1996)

[58] Where the bank regulator was a consolidated supervisor, it was to extend such meetings to include the group internal audit function. It was also required to meet chairmen of audit committees where large incorporated institutions were involved.

[59] At the time, these were section 39 reports

foreign bank branches), the application issues for standards and monitoring tools – as highlighted by the Basel Committee in its Consultative Document,[60] focus on issues which include i) the frequency with which banks calculate and report metrics, ii) the scope of application of these metrics and iii)public disclosure.[61] In relation to these issues, the Basel Committee on Banking Supervision proposed that metrics should be used on an ongoing basis to help monitor and control liquidity risks.[62] Furthermore, it stated that banks are not only expected to meet the requirements of the standards on a continuous basis, but that metrics should be calculated and reported at least monthly.[63] In relation to the scope of application of the metrics, it was stipulated that "proposed standards and monitoring tools were to be applied to all internationally active banks on a consolidated basis", as well as consistently.[64] With particular emphasis on standards, the need for transparency and public disclosure of information on the metrics was also highlighted.[65]

The Basel Committee's observations in relation to the above mentioned application issues signify a growing emphasis on disclosure, transparency as well as the need for greater frequency in relation to financial reporting. The financial environment which characterises the present global markets is one which embodies more complex risks than those which existed during the collapse of Barings Plc. Further, whilst emphasis was placed on internal controls and consolidated supervision (as regards Barings), recurring problems in recent corporate collapses relate to off balance sheet instruments and the need for a consideration of the substance of transactions (such creative compliance practices being related also to internal controls and consolidated supervision).

Although the Board of Banking Supervision's recommendations (post Barings collapse) focussed primarily on the extension of the scope of prudential supervision to consolidated undertakings, the frequency of monitoring - along with public disclosure, are factors which necessitate the implementation of increased levels of monitoring, transparency and disclosure – particularly in this time and age of more complex risks and occurrences of rampant and rife practices of creative compliance.

G. The Role of the External Auditor in Implementing and Utilising Regulatory Standards and Monitoring Tools

As well as facilitating accountability, increased formalisation with risk assessment tools would reduce possibilities of the regulator being "captured" by the regulated. However, more formalised procedures in the application of rules also has implications for the observation of "substance over form" transactions. Problems which ultimately resulted in Enron's collapse were partly attributed to a rules based approach to regulation – such an approach having contributed to creative compliance.[66]

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[60] Consultation Document on International Framework for Liquidity Risk Measurement, Standards and Monitoring at page 31

[61] Ibid; a fourth application issue which was also considered in the Consultation Document relates to currencies. However this will not be considered for the purposes of study within this paper.

[62] ibid

[63] „With the operational capacity to increase frequency to weekly or even daily stresses situations - at the discretion of the supervisor." ibid

[64] ibid

[65] „Required disclosure for the standards are to be similar to the disclosure of capital positions." ibid

[66]„Enron aggressively employed special purpose entities (SPEs) which were not consolidated into Enron's financial statements and were treated as arms length parties for the purposes of Enron recording income from its dealings with these entities. Consolidation of such an entity is required unless, amongst other considerations, an independent third party holds a majority of the outstanding voting interests in the entity and the third party equity investment is equal to at least three per cent of the SPE's total assets.If one considers the application of a three

Following the collapse of Barings and according to the Bank of England's Review of Supervision,[67] the Arthur Andersen review (supported by the Bank's Review of Supervision) suggested that the use of formal risk assessment models will imply a need "to bring the line supervisors into direct contact, on site, with a wider range of management."[68]

In implementing the regulatory standards and monitoring tools which are highlighted by the Basel Committee in its consultative document,[69] a supervisory approach which not only incorporates the expertise of external auditors, but which is also more inclined to an on site system based approach is recommended. In supporting this view, reference is made to lessons learned from the collapse of Barings where it was noted by the Treasury Committee that "it was due to the discretionary basis of the supervisor's approach to supervision that there was limited ability to detect events at Barings."[70]

The regulatory standards and monitoring tools set out in the BIS Consultative Document[71] are therefore supported on the basis of their ability to facilitate a more formal approach to supervision which would reduce the scope for flexibility (scope for creative accounting practices and "window dressing" of balance sheet figures) where an on – site approach to supervision is implemented. However, increased formalised procedures, coupled with on site supervision do not suffice in the efforts to combat practices related to "creative compliance". The importance of implementing a system of supervision which accords due consideration to the substance of transactions will be considered in the penultimate section of this paper (under principles based regulation).

II. On site and Off site systems of supervision

Principle 21 of the Basel Core Principles for Effective Supervision*, Supervisory reporting* states that **"**Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts."

According to Vieten,[72] bank regulation has followed two trends, namely: supervision has become increasingly formalized and dependent on quantitative tools, and secondly, regulatory duties are being pushed down a regulatory pyramid to include external auditors and to enlist the resources of regulatees.

External auditors, even though they do not constitute by definition, part of a banking organisation, immensely impact the quality of internal controls "through their audit activities

per cent bright line rule it quickly becomes apparent that a considerable amount of interpretative judgment is required in its application." See D Kershaw, „Evading Enron: Taking Principles Too Seriously in Accounting Regulation" (2005) 68 (4) Modern Law Review 594-625 at page 616

[67] July 1994 paragraph 14

[68] See Treasury Committee Barings Bank and International Regulation Report No 1 (1996) at xiv

[69] See Consultative Document ,International Framework For Liquidity Risk Measurement, Standards and Monitoring December 2009

[70] Treasury Committee Barings Bank and International Regulation Report No 1 (1996) at page xiv

[71] Consultative Document ,International Framework For Liquidity Risk Measurement, Standards and Monitoring December 2009

[72] See HR Vieten, „Banking Regulation in Britain and Germany Compared: Capital Ratios, External Audit and Internal Controls" (1997) at page 18

– which also includes discussions with management and recommendations for improvement to internal controls."[73] "External auditors provide an important feedback on the effectiveness of the internal control system."[74]

Off site supervision is synonymous with monitoring and involves the regulator's use of external auditors' expertise. It also involves the receipt and analysis of financial statements and statistical returns submitted to the supervisors. Off site monitoring often has the benefits of being able to identify potential problems, particularly during intervals between on- site inspections, thereby providing early detection and acting as trigger for corrective action before problems become more serious.[75]

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. Furthermore, it is contended that on-site examinations are frequently implemented by banking supervisory authorities which posses the legal basis or other arrangements to direct the scope of the work carried out by external auditors.[76]

Ongoing monitoring is contrasted with separate evaluations. It is highlighted that whilst ongoing monitoring activities not only provide the advantage of "quickly detecting and correcting deficiencies in the system", but are also most effective "when the system of internal control is integrated into the operating environment and produces regular reports for review," that separate evaluations usually detect problems "only after the fact."[77] However separate evaluations also offer the advantage of providing an organisation with "fresh and comprehensive" insight into the effectiveness of monitoring activities – such activities being undertaken by staff from different departments which include the business function, financial control and internal audit.[78]

H. The Efficiency of Internal and External Monitoring Devices as Tools for facilitating Accountability, Transparency and Disclosure.

I. An Evaluation of External and Internal Control Based Systems of Governance

This section of the paper aims to shed light on how the present and more external control based system of corporate governance in Germany could respond to criticisms related to transparency, monitoring and accountability. Furthermore, it will consider how and whether banks have a role to play in corporate governance – particularly towards facilitating greater levels of monitoring and accountability.

Audit committees are not only regarded as internal monitoring devices supportive of good corporate governance, but also considered to be mechanisms for ensuring that an appropriate

[73] Framework for Internal Control Systems in Banking Organisations, page 25 Basel Committee on Banking Supervision 1998
[74] ibid
[75] See „The Relationship between Banking Supervisors and Banks' External Auditors January 2002 paragraph 40 page 11 <http://www.bis.org/publ/bcbs87.pdf?noframes=1>
[76] See Framework for Internal Control Systems in Banking Organisations, Basel Committee for Banking Supervision 1998 at page 23
[77] ibid at page 20; Examples of ongoing monitoring include the review and approval of journal entries, management review and approval of exception reports; ibid
[78] ibid

relationship exists between the auditor and the management whose financial statements are being audited.[79] In contrast to the audit committee, a two tier system of disclosure exists in Germany – which was conceived as a management control function.[80] As well as performing the role of preparing two mandatory reports (an "internal long form report" – directed to the supervisory board and management and an "external summarized report"), the *Wirtschaftsprüfer* is also introduced as an external expert who reports to the supervisory board on matters relating to the financial state of the company – since the board is not considered to be competent enough to form an adequate opinion in the absence of such external expert.[81]

The typical public limited liability company in Germany is comprised of two boards of directors, namely:[82] i) The supervisory board (*Aufsichtsrat*) – which could be described as the equivalent of an audit committee and ii) the management board (*Vorstand*). Whilst the management board is responsible for conducting daily operations and is accountable to the supervisory board, the supervisory board maintains oversight over the management board, "having the power to appoint and dismiss members of the management board , and also to stipulate their salaries."[83]

In drawing comparisons between the German and British corporate governance systems, Vieten is of the opinion that "it is also improbable that the Cadbury proposals can effectively curtail the powers of the dominant interested party , namely the management" and that audit committees may "constitute no more than symbols of control" – having due regard to the German system which "invests power in non executive directors by statute – failing to prevent scandals."[84]

"The German corporate governance system is generally considered to be a standard example of an insider-controlled and stake holder-oriented system."[85] However, transformation from this classic and traditional "insider-controlled" system to a "modern capital market based and outsider controlled" system has been observed.[86] The advantages of the traditional insider systems were considered to include:[87]

- i) Its ability to enable management to take a longer-term perspective in its planning and strategies
- ii) As a result of the need to finalise incomplete and implicit contracts, it offered the benefit of flexibility and created stronger incentives to undertake relationship- specific investments than a market based and purely shareholder-oriented outsider control system."

[79] V Beattie, S Fearnley and R Brandt *Behind Closed Doors: What Company Audit is Really About* (ICAEW) 2001 at page 29
[80] H R Vieten, 'Auditing in Britain and Germany Compared : Professions, Knowledge and the State' European Accounting Review at page 506
[81] ibid
[82] See G Gorton and F Schmid, 'Universal Banking and the Performance of German Firms' NBER Working Paper 5453 1996 at page 28
[83] ibid
[84] H R Vieten, 'Auditing in Britain and Germany Compared : Professions, Knowledge and the State' European Accounting Review at pages 506 and 507; In Vieten's view, no proof has been provided to suggest that audit committees may improve corporate governance and audit independence; see ibid at page 506
[85] See RH Schmidt, „Corporate Governance in Germany: An Economic Perspective" 2003 page 2 of 44
[86] ibid at page 22 of 44
[87] ibid at page 18 of 44

Identified weaknesses of the system include criticism that: "The supervisory board does not function in the way it was intended to function."[88] As well as the reliance of the insider control system on informal contracting being considered to have contributed to "lack of transparency" and its anti competitive effects", "a systematic neglect of the stock market, greater opportunities for abuse of power, the real danger that such as system is inimical to all reforms – even those which might improve its functioning without altering its fundamental structure," are further criticisms attributed to an insider control system.[89]

II. Facilitating and Fostering Greater Frequency of Monitoring Procedures: The role of independent external experts in corporate governance

This section aims to demonstrate how corporate governance systems could facilitate higher levels of monitoring.

The German system of corporate governance is distinguished from that which operates in Anglo Saxon countries owing to its incorporation of lenders and employees in the governance of large corporations.[90] It views corporations as entities which serve the interests of shareholders –as well as other interests, and is defined by a legal tradition which can be traced back to the 1920s.[91]

Two features which distinguish the German system of corporate governance from that of the US and the UK include:[92]

- Less dispersed/Higher concentration of the ownership of large firms. In countries like the UK and the US where ownership is more dispersed, it is argued that "control is exerted by managers with considerable freedom to pursue their own interests at the shareholders' expense – since their actions are not monitored adequately."[93] It is argued further that there is little incentive for individual shareholders to monitor since they are individually responsible for any accrued monitoring costs – even though such monitoring ultimately serves the benefit of all shareholders.[94]

- Involvement of banks as part of supervisory boards of companies (as shareholder representatives). This allows banks to monitor the management of companies – particularly when a banker assumes the head of the supervisory board. The election of banks to the supervisory boards of companies (as shareholder representatives and sometimes as heads of supervisory boards), provides them with invaluable insight which facilitates their ability to monitor the management of companies.[95]

[88] ibid at page 19 of 44
[89] see ibid
[90] See RH Schmidt „Corporate Governance in Germany: An Economic Perspective" 2003 at page 2 of 44
[91] ibid at page 3 of 44
[92] J Edwards and M Nibler „Corporate Governance in Germany: The Role of Banks and Ownership Concentration." 2000 Journal of Economic Policy 31: 237-260
[93] ibid at pages 239 and 240
[94] ibid
[95] ibid at page 241; This being the case where a banker assumes the head of the supervisory board – owing to the fact that the chairman is frequently consulted by the management (usually on a monthly basis) – whilst the full board may hold meetings twice a year; ibid.

A further characteristic which distinguishes Germany from stock market economies exists in the way in which voting occurs at annual meetings.[96] Whilst both stock market economies[97] and universal banking systems[98] share the common feature of enabling shareholders to exercise control over management (through votes at general meetings), in Germany, banks also own their equity[99] and "have proxy rights to vote the shares of other agents who keep their shares at the bank."[100] The importance of proxy voting rights stems from the fact that "it concentrates the voting power of dispersed household shareholders in the hands of banks – making them potentially powerful."[101] The influence of banks (with or without proxy voting rights) may have altered dramatically over the years owing to the different world of German corporate finance which currently persists. Apart from the fact that security markets have become more developed and complex, the extent of banks' block holdings has, correspondingly, also become very much reduced.[102]

Having considered the above features, it can be inferred that the inclusion of banks as part of the supervisory boards of companies, and less dispersed ownership of large firms have the benefits of facilitating higher monitoring levels. However, as observed by Schmidt,[103] the Stock Corporation Act *(Aktiengesetz*) accords to the management board *(Vorstand*) a wide scope in the discharge of their powers. Furthermore, Edwards and Nibler argue that although banks may influence corporate governance through their control of proxy votes, their presence on supervisory boards, and their provision of loan finance, they do not play a role in the governance of large German firms in practice – that is, a role which is distinct from that of other types of large shareholders.[104] They arrive at the conclusion that "any case for the superiority of German corporate governance of large firms" must accordingly "be based on high ownership concentration rather than a special role for banks" – as well as a consideration of the costs of ownership concentration and its benefits."[105]

The dual system of disclosure which exists in Germany should facilitate greater accountability and disclosure. Furthermore, it should reduce the scope for the abuse of powers – if an adequate degree of independence existed within the supervisory board. In addressing how the present and more external control based system of corporate governance in Germany could respond to the criticisms of the "insider based system of control" as highlighted under the last paragraph of section H subsection (I), independence and objectivity would best be enhanced

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[96] G Gorton and F Schmid, 'Universal Banking and the Performance of German Firms' NBER Working Paper 5453 1996 at page 1

[97] Such as the UK and the US.

[98] For instance, Germany.

[99] As well as having the capacity to lend

[100] ibid; Such right being referred to as *Auftragsstimmrecht.* The bank requests for permission to vote on behalf of the shareholder. Even though such a right is typically granted and lasts for about 15 months, it could still be revoked. Even though such a right has its limits, it enables banks to exercise a degree of influence on management irregardless of banks' equity holdings in the firm; ibid.

[101] ibid at page 2; Other ways through which banks could exert control over firms (even though such banks may appear to have insignificant equity holdings), include: i) "where the bank retains proxy rights – in addition to the votes attributed to their shares; (ii) where restrictions on voting (which prevents a block holder from exercising control) exists – such restrictions do not apply to bank proxy voting – giving banks unique power to the extent that they vote proxies; (iii) where block holders may have votes, but not enough information to use their power effectively – whilst banks, on the other hand, may have privileged information which they could use to their advantage – even if their holdings are small and even though a large block holder is present." See ibid at page 10

[102] See ibid at pages 30 and 31

[103] RH Schmidt „Corporate Governance in Germany: An Economic Perspective" 2003 at page 10 of 44

[104] J Edwards and M Nibler „Corporate Governance in Germany: The Role of Banks and Ownership Concentration." 2000 Journal of Economic Policy 31 at 237; The scope of banks in influencing corporate governance "through an exercise of proxy votes and their representation on supervisory boards", as further argued by Edwards and Nibler, "does not apply to all German firms."

[105] ibid

where the supervisory board were to be comprised of external independent experts such as bank managers or other qualified experts within the financial sector who also had the capacity to curtail excessive powers of management in circumstances where such management is considered to have acted beyond the scope of its powers.

Whilst the weaknesses of an insider controlled system of corporate governance have been highlighted, it is also important to add that an insider controlled system serves as a valuable source of acquiring information and understanding about a firm or company – which could otherwise, not be provided by an external expert. Common characteristics which audit committees and supervisory boards should ideally have, as revealed in a survey[106] include: "That non executive directors have relevant industry experience; that some members should have sound grasp of current developments in financial markets; that there should be openness to regular training; that there should be distinct appointment policies and criteria; succession planning and membership criterion; that there should be clear delineation between their role and that of management; that there should be clear strategies for setting an appropriate control culture within their organisations; that there be regular, clearly structured meetings held at least four times a year; that there exist regular flow of relevant, timely information from company executives; private meetings meeting internal and external audit leaders; and the existence of self-assessment procedures."

Supervisory boards and audit committees should not only ensure that directors and management are held accountable to shareholders, but also safeguard independence in matters related to the preparation, approval, audit of the financial statements. The Combined Code of Corporate Governance provides that "the audit committee should consist of at least three independent non-executive directors[107]. Furthermore, the board should satisfy itself that at least one of those independent non executive directors has recent and relevant financial experience." Compliance with the Code's recommendations for independence requires an exclusion of former finance directors and auditors from the board.[108]

I. Principles Based Regulation

This section illustrates how principle based regulation could be employed effectively to mitigate criticisms which are attributed to principles based regulation – which include its potential to impede efforts aimed at fostering accountability and efficient monitoring procedures. Such criticisms stem from the ability of "bright line rules"/rules based regulation to enhance clearer segregation of duties – which enhance accountability and delegation of monitoring procedures than an approach which is more inclined to principles base regulation. Despite its merits, "rules (and low level principles) should not be able to get in the way of what is really going on in the real business world."[109]

A discretionary based approach to regulation, whilst encouraging greater possibilities for regulatory capture, appears to be more congruent with principles based regulation. However it is possible to implement a system of regulation which combines increased formalised procedures and/or detailed rules - whilst giving due consideration to the substance of transactions.

[106] See V Beattie S Fearnely and R Brandt, *Behind Closed Doors: What Company Audit is Really About* ICAEW 2001 at page 29

[107] „Or two if the company is not classified within the FTSE 350"

[108] See „Combined Code on Corporate Governance" <http://www.out-law.com/page-8219>

[109] D Kershaw, „Evading Enron: Taking Principles Too Seriously in Accounting Regulation" (2005) 68 (4) Modern Law Review 594-625 at page 611.

“Principles provide the framework in which firms can organize their own processes to achieve the outcomes the regulator seeks – the regulator in turn depends on firms to adopt an attitude to the regulatory regime which is one which aims to go beyond minimal compliance with rules.”[110]

Principles based regulation is not only advantageous because it allows management of a bank or firm to take into consideration the substance of transactions, but because “principles impose outcomes to be achieved – not detailed processes for achieving them.”[111] As well as being linked to meta regulation, principles based regulation facilitates a system whereby principles “communicate regulatory objectives and promote behaviour which will achieve those objectives.”[112]

Principles based regulation, thus, would not only reduce the scope for “creative compliance” – since the substance of transactions should be considered by management, but also has the benefit of providing a more flexible and responsive approach to regulation as this section will seek to demonstrate.

Principles based regulation is considered to comprise of 3 elements, namely:[113]

i) A particular type of rule
ii) A focus on outcomes and
iii) A focus on senior management responsibility in ensuring these outcomes are achieved

Furthermore, three forms of principles based regulation, namely: “formal principles based regulation; substantive principles based regulation and full principles based regulation”, have been suggested.[114] For the purposes of this paper, the discussion will focus on substantive principles based regulation.

- Five classes of regulatory practices which could characterise substantive principles based regulation include:[115] “The particular mode of interpretation- that is, the approach taken in the interpretative process; particular enforcement style; an orientation to outcomes; a relocation of responsibilities for working out the practical application of the provisions; and an explicit and developed reliance on management based regulation.”

The effectiveness of rules and regulation is dependent, not only on the monitoring processes and tools used in such processes, but also the effectiveness of the enforcement of those rules. For this reason focus will be dedicated to the second characteristic of substantive principles based regulation – which is indeed a “critical” and defining feature of principles based regulation.

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[110] See J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 9 http://www.lse.ac.uk/collections/law/wps/wps.htm and http://www.ssrn.com/abstarct=1267722
[111] ibid
[112] ibid at page 16
[113] See J Black, „Forms and Paradoxes of Principles Based Regulation“ LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 12
[114] ibid
[115] ibid at page 17

According to Black, the adoption of the "responsive" enforcement approach is justified on the basis that "neither negotiative approaches nor deterrence based approaches are effective on their own and that instead, regulators should implement a mixture of both, that is, first negotiate, then if the firm still does not deliver substantive compliance, regulators should gradually move up the enforcement pyramid, applying sanctions of increasing severity until it does."[116] She adds weight to Baldwin's argument[117] by stating that "those who know what they are meant to be doing and are generally inclined to do it ("the well intentioned and well informed") , are best dealt with using a negotiating strategy – which is easier to do using principles. In contrast, those who do not know what they are meant to be doing and even if they did, would not be inclined to do it ("the ill intentioned and ill informed"), are best dealt with using a strategy that escalates rapidly up the enforcement pyramid."[118]

This "responsive" approach, it is further argued, "is not contingent on any particular rule design and can operate in systems of i) highly detailed rules, ii) where the rules are mainly principles, iii) where there is a combination of both."[119]

A system which consists of highly detailed "bright line rules" is advantageous both from the perspectives of fostering a higher degree of accountability and providing greater guidance in terms of compliance. This is very important in respect of junior management who have less experience with the interpretation of rules and who also require greater guidance in matters relating to compliance. The following paragraph not only highlights the weaknesses inherent in principles based regulation, but also illustrates why it is better suited for senior management.

Having considered the forms, attributes and benefits of principles based regulation, the weaknesses inherent in this type of regulation are worth mentioning. Firstly, in relation to the all important aim of ensuring accountability – which should be fostered if adequate monitoring procedures are observed and carried out by the responsible levels of authority. Principles based regulation could serve as a hindrance towards ensuring accountability. In this respect reference will be made to the seven paradoxes of principles based regulation – which are as follows:[120]

- "i) The interpretative paradox : Different interpretations attributed to principles could result in imprecise and general terms being accorded very specific interpretations – even though principles are supposed to offer flexibility (where these are characterised by imprecise terms).
- ii) The communicative paradox: Principles, whilst facilitating communication, could also hinder such communication. The paradox is attributed to the distinction between legal use of language and its ordinary use.

[116] See also I Ayres and J Braithwaite, *Responsive Regulation* (1992) Oxford University Press

[117] See R Baldwin, *Rules and Government* (1995) Oxford Clarendon Press

[118] J Black, „Forms and Paradoxes of Principles Based Regulation" LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 19; She argues that "in a regime with a tough, punitive approach in which every infraction is met with a sanction, principles based regulation (PBR) would not survive – this being the case, because there is greater risk that firms will make the wrong assessment ie one with which the regulator does not agree." Under principles based regulation, she argues further, "firms are required to think through the application of the provisions to particular situations to a far greater degree than they are with respect to a detailed rule – hence the higher probability that firms would make the wrong assessment ." See ibid at page 18

[119] J Black, „Forms and Paradoxes of Principles Based Regulation" LSE Law, Society and Economy Working Papers 13/2008 (2008) at page 19; It is further argued that "Different rule types make it easier for regulatory officials to deal with certain types of regulated firms."

[120] See ibid at pages 25 -35

- iii) The compliance paradox: Principles provide scope for flexibility in compliance – however this could result in conservative and/or uniform behaviour by regulated firms.
- iv) The supervisory and enforcement paradox: Principles require enforcement to provide them with credibility – however over-enforcement could result in their demise.
- v) The internal management paradox: Principles based regulation has the potential to offer required flexibility for internal control systems to develop – and also the potential to overload them.
- vi) Ethical paradox
- vii) Trust paradox

Based on their level of professional experience, senior management should have less interpretational difficulties than junior and less qualified employees. For these reasons, principles are best implemented by qualified, experienced senior management who have held a reputable track record with a company. A combination of bright line rules and principles are favoured in relation to the choice between detailed rules, principles and a combination of both. The crucial question/s would be i) the point at which a departure from the systematic application of rules should occur – where such an application would render a consideration of the substance of transactions as infeasible. ii)The importance of efficiently communicating the need to switch from rules to principles – a function of senior management (which would be best achieved where a clear system for the delegation of responsibilities exists). However, the topic addressing these questions is beyond the scope of this paper.

A detailed consideration of the paradoxes of principles based regulation highlights the importance of having a clear understanding of the form of principles based regulation which is applicable to a particular bank or business. As highlighted under the substantive principles based regulation, "those who know what they are meant to be doing and are generally inclined to do it (the well intentioned and well informed), are best dealt with using a negotiating strategy." Hence a more draconian mode of enforcement, that is, the imposition of tougher sanctions, would not be best suited in facilitating compliance by such groups – such sanctions being better reserved for the "ill informed and ill intentioned." Furthermore, a tough punitive regime is one in which principles are unlikely to survive – even though detailed rules could still be implemented under principles based regulation.[121]

Hence the level of compliance desired within a firm is best achieved having regard to the organisational structure which exists within an organisation – and to whether (as a result of a such determination), that organisation could be considered a suitable candidate for the application of principles based regulation. Clear delegation and segregation of duties within an organisation would not only promote accountability, but would also facilitate a system where principles could be applied and also facilitate monitoring procedures. Consequently, monitoring would also facilitate accountability – since frequent reviews and discussions between management and appropriate personnel should increase an understanding of the activities carried out by particular divisions within the organisation.

J. CONCLUSION

Monitoring fosters transparency, which in turn fosters accountability. Monitoring of key risks, as well as periodic evaluations by the business lines and internal audit constitutes a vital

[121] Refer to Formal Principles Based Regulation; ibid at page 12

element of corporate governance – hence the overall effectiveness of a bank's internal controls should be monitored on an ongoing and frequent[122] basis.[123]

Since it is possible for detailed rules to operate under principles based regulation – and since detailed rules constitute a vital element in ensuring that clear delegation and segregation of responsibilities exist within an organisation, it could be said that the level of accountability derived under principles based regulation is dependent on the form of principles based regulation. Under the formal principles based regulation, the level of accountability derived is likely to be greater than that derived under full principles based regulation. As highlighted within the relevant sections of this paper, an approach which combines negotiating and punitive strategies is always considered best – owing to the level of flexibility offered by such an approach. However the organisational structure, culture and several other factors require consideration before substantive principles based regulation is judged to be the optimal approach.

In accordance with Principle 13 of the Principles for the Assessment of Internal Control Systems, "supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and- off balance sheet activities and that corresponds to the bank's environment and conditions." Furthermore, "in those instances where supervisors determine that a bank's internal control system is not adequate or effective for that bank's specific risk profile, they should take appropriate action." In accordance with Core Principle 17 of the Basel Core Principles for Effective Bank Supervision, *Internal controls and audit*, specific attention should be given to ensure the existence of "clear arrangements for delegating authority and responsibility." Indeed, a key to successfully implementing principles based regulation lies with Core Principle 17 – which, if complied with, should resolve many problems and paradoxes associated with principles based regulation.

Where clear delegation of authority, segregation of responsibilities are not in place, the most appropriate and obvious action might be to initiate a more deterrence based approach – rather than a negotiative based approach. However, reference must be made to factors highlighted under the first paragraph of this conclusive section.

Increased formalisation under principles based regulation would still allow for a consideration of the substance of transactions – whilst allowing for flexibility in terms of its application. With regards to its application, this implies its suitability as the appropriate mode of regulation - based on the level of accountability it could provide an organisation with and whether an organisation, because of its structure and culture, should consider applying it at all.

[122] "The frequency of monitoring different activities of a bank should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment." See Framework for Internal Control Systems in Banking Organisations at page 20 http://www.bis.org/publ/bcbs40.pdf
[123] See also Principle 10 of the Principles for the Assessment of Internal Control Systems; Framework for Internal Control Systems in Banking Organisations at page 20 http://www.bis.org/publ/bcbs40.pdf. "Monitoring the effectiveness of internal controls could be undertaken by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that senior management clarify which personnel are responsible for which monitoring functions." Further, "monitoring should constitute part of the daily activities of the bank – whilst including separate periodic evaluations of the overall internal control process. ";ibid

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