

# Regulation risk and compliance



In a last couple of decades, there have been a lot of policies and strategies in financial services and financial markets such as the Basel II, Sarbanes-Oxley, European Union's Financial Services Action Plan – the MiFID and Solvency II, and the complex anti-money laundering rules. Basel 11 aims on promoting sufficient capitalization of banks and encourage innovations in risk management to help strengthen the financial system. It is composed of three connected pillars that boost the banks' quality of control processes.

Pillar 1 is the capital framework based from 1988 Accord's guidelines intended to maintain the minimum capital requirements to the banks' risk of economic loss. Financial institutions with higher risk of economic loss are required to maintain a higher minimum capital ("Basel 11"). Originally, a Basel Committee was established in 1974 among central bank Governors of the Group of Ten countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom, and United States. The Governors meet four times annually to formulate supervisory standards, recommends practices applicable to every member's national systems, and encourages convergence of common standards.

However, the Committee does not possess authority and legal force that allows implementing rules strictly; but there is a formal agreement among country members that every foreign banking institution should be under adequate supervision (2006). The Committee formulated a capital measurement system better known as the Basel Capital Accord in 1988; where a credit risk framework is implemented with 8% minimum capital standard aimed by 1992. In 1998, the Committee introduced a revised framework called Capital Adequacy Framework which was consisted of three

pillars including the minimum capital requirements (first pillar), review of a bank's internal assessment process and capital adequacy, and complementing effective use of disclosure for market discipline with supervisory efforts. The new framework was introduced in 2004 in use for transacting with other banks, industry groups, and supervisory non-member authorities (2006). In the Twentieth Annual Meeting of the Council of the Governors of Arab Central Banks and Monetary Agencies held at Beirut, Lebanon on 2005, Andrew Crockett – President of JPMorgan Chase International discussed the economic consequences of Basel II.

He argued that Basel II aimed on improving the performance of financial capital efficiently to yield higher and efficient investments for 'higher rates of output growth and living standards. There are criticisms that it will be disadvantageous for smaller firms, but Crockett argued that small institutions can 'offset marginal savings in regulatory capital' because they are 'closer to the customers and often specialized. Another issue raised was the sensitivity to risk management which could lead to higher cost of borrowings for some borrowers. He explained that greater risk management will make some assets attractive to regulatory capital requirements with others having lower requirements. The borrowing cost might increase for some borrowers, but he argued that losers were not actually losing much. He further added that Basel II is beneficial for emerging markets since risk are properly priced and the capital is risk-adjusted where return is at its highest (Crockett 2005).

Another change in the financial system is the Sarbanes-Oxley Act specifically affecting the corporate governance where public companies and the

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accounting profession seemingly progressed in meeting its requirements (2005). The Act was introduced in 2002 in the United States, named after Senator Paul Sarbanes and Representative Michael Oxley, focusing mainly on the regulation of financial practice and corporate governance. Oxley thought that this legislation might heighten ‘undue risk aversion’ from firms who fear of violating the requirements. Sarbanes, on the other hand, believed that this would force firms “to clean up their acts” (Koehn and Vecchio 2004).

The most important sections regarding compliance were 302, 401, 404, 409, 802, and 906 (2003). Section 302 or ‘Corporate Responsibility to Financial Reports’ is under Title III of the act. It pertains to the requirements of periodic statutory financial reports: the signing officers must have reviewed the report, it must contain untrue and misleading information or omit details, its content must complement the financial condition and all the results, the signing officers must have evaluated the internal controls ninety days earlier and reported their findings, deficiencies and information on fraud must be included, and significant changes in internal controls that might have a negative impact. Institutions are restricted to avoid any of these requirements by transferring their activities outside the United States (2003). On the other hand, Section 401 which is under Title IV known as ‘Disclosures in Periodic Reports’ pertains to the requirements of financial statements. The financial statements should be accurate and true and must contain all off-balance sheet liabilities, obligations, or transactions.

The Commission will check and report any incorrect statement to come up with a transparent reporting (2003). Moreover, Section 409 or ‘Real Time Issuer Disclaimer’ pertain to disclosing the financial information to the public

as early as possible and is easy to understand supported by graphical presentation (2003). Section 802 or ' Criminal Penalties for Altering Documents, which is listed under Title VIII includes penalties such as fines and twenty year-imprisonment if proved of altering, destroying, mutilating, concealing, falsifying information, or impeding investigation. Accountants, on the other hand, who are found of willfully violating the maintenance requirements, will be subject to ten years of imprisonment (2003). In an article The Ripple Effects of the Sarbanes-Oxley Act (2004) written by Jo Lynne Koehn, professor of accounting and CPA, and Stephen Del Vecchio, assistant professor in accounting and CPA, they argued the weaknesses and negative impacts of the Act. This law has been the most significant since 1934 which aimed on restoring the confidence of the investors and prevent fraud.

However, the Act has caused mergers and acquirers to hold back assuming that they would acquire the financial liabilities of the acquired private companies. It has also made the audit committees a rigorous job. According from the survey conducted by the Deloitte & Touche LLP, it was found out that committee meetings are now taking longer than before the Act was passed. Committees are now meeting frequently and working for hours unlike before where they would meet for less than an hour (Koehn and Vecchio 2004).

Registration for the Public Company Accounting Oversight Board (PCOAB) by accounting firms, who provides services for public companies, has become costly due to additional operating costs, higher liability insurance cost, staff training cost, and higher liability risk. In October 2003 deadline of

registration, only 598 firms were able to register out of a thousand. The Act has also significantly decreased the competitiveness of the audit market especially if a large firm is sanctioned. Compliance with Section 404 has also increased the accounting costs since it requires firms to assess an internal control system which is equivalent to 1% of their earnings or \$7 billion a year.

It has affected the records management even if destruction of records is part of the firm's policy and there is no legal investigation, companies may be subjected to criminal liability. Additionally, there has been an increase with consulting solutions such as software implementation and added more work for lawyers. The implementation of Sarbanes-Oxley has greatly extended its reforms and 60% of 200 senior executives seem to agree, according from the Foley & Lardner survey (Koehn and Vecchio 2004). In Europe, there are also significant legislations intended for financial markets which are under the E. U.

's Financial Services Action Plan (FSAP). E. U. s main objective is a Single Market for financial services, prepared by the HM Treasury, the Financial Services Authority (FSA), and the bank of England.

This aims on achieving competitive opportunity for the financial sector, corporate sector, and the consumer group (2003). However, financial firms are wary on how much it would cost them for the compliance. In 1995, Investment Services Directive (ISD) was introduced however it was replaced with MiFID, Market in Financial Instruments Directive. MiFID included the coverage of ISD and has extended reforms on business management and

internal controls. It extends core investment services such as upgrade advice involving personal recommendation, introduction of multilateral trading facility (MTF), and extension of the coverage of passport for commodity derivatives.

It requires transparency on corporate governance and business organization of investment firms and tighter reporting of requirements. Firms both under ISD and not will be covered of MiFID such as investment banks, portfolio managers, stockbrokers and broker dealers, corporate finance firms, and other firms (Salamero 2006). Companies think that the MiFID is a replacement for a failed ISD. Since it requires keeping records for five years, firms needed to automated systems and communications infrastructure which would cost them of approximately ? 10 million for the technology and another ? 12 million for new processes. The total is estimated to be around ? 1 billion. The FSA has warned firms to be prepared and companies are taking it seriously while others do not (Ranger and Ferguson 2007).

The MiFID has opened job opportunities for IT professionals especially for firms where technology is critical and complex. However, it is feared that the conventional IT infrastructures will become obsolete. The liberalization of market has increased the number of venues for share trading and reporting therefore encouraging more buying and selling of shares to increase market competitiveness. Investment banks established trading exchanges venues for the London Stock Exchange such as Turquoise and Project Rainbow; and MarkitBoat for reporting venues (Finders 2008). The new directive has taken into effect November 2007 and firms are still anticipating the real impact in the future.

Solvency II is another project by the EU intended to reform prudential regulation of insurance and deal with the function of insurance sectors in risk management and capital allocation. A single market of insurance services can contribute to the flexibility and dynamism in the global economy where users and providers will benefit maintaining an efficient allocation of capital. There have been changes in the EU's solvency framework since the 1970s because of the complexity of risk management and appropriate model to measure the risks faced by insurers. Solvency II was formulated to promote quality risk management and ensure assessment of regulatory capital (2006).

The target date for the implementation of Solvency II is in 2010 in Europe. It reflects the Basel II approach which has three proposed pillars: (1) quantitative capital requirements, (2) qualitative supervisory review, and (3) market discipline. Market discipline covers issues on transparency, disclosures, and risk-based supervision through market mechanisms (Muelders 2008). Solvency II will have a significant effect on the firms' regulatory capital requirements, governance, and risk and capital management processes. There will be a higher regulatory capital requirement; changes in calculation and management of capital due to requires risk-based capital requirements; changes in capital allocation; higher qualifications for analysts, policyholders, and regulators; increase in the role of regulators due to regulatory regime focusing on risk and capital management; and increase supervision among territories (2008).

The implementation of Solvency II is years to come and there are a number of consultation papers studying the its impact. New rules and legislations



have been introduced to increase Europe's competitiveness and also balance, such as the rules on money laundering. The European Union introduced the Third Money Laundering Directive which also has a significant impact on the financial activities. The FSA will be regulate laundering controls in Authorized Firms, safety deposit box providers, leasing companies, share registrars, and commercial lenders. Under the new regulation, Authorized Firms should inform the FSA if they are money service businesses, trust, or company services providers; if they operate on currency exchange; if there is money transmission; if the cashes cheques; and if it is subject to EU's Payments Regulation (2008).

Money laundering has become rampant in different sectors of business. Combating money laundering is time-consuming especially for the finance directors. Money laundering is a criminal attempt which comes in different forms such as concealing the true origin of proceeds of theft, fraud, terrorism, and drug-trafficking; and attempting to use funds such as financing arms trade for illegal purposes. Placement of illegal funds into legal finance is also money laundering. Re-integration of illegal funds to legal financial system by criminals is another example of laundering. Financial institutions like banks, insurance companies, and gaming companies; even accountants, fund managers, auditors, lawyers, stockbrokers, or traders participate in money laundering.

There various anti-money laundering regulations aside from the EU Third Money Laundering Directive such as the UK FSA Money Laundering Directive 2007, UK Serious Organized Crime and Police Act 2005, US Patriot Act 2001, US Money Laundering Control Act 1996, US Bank Secrecy Act 1970, an <https://assignbuster.com/regulation-risk-and-compliance/>

Australia's Anti-Money Laundering and Counter-Terrorism Financing 2006 (Abrahami 2008). The anti-money laundering laws have made a rigorous job for the chief financial officers and executive officers not to deal with money-launderers, terrorists, or cover up for related activities. The laws are difficult to regulate and comply with because the business transactions are international in nature. There are national and international regulations and there are questions on which among the regulations should the firms comply. Obviously, finance directors should comply with the laws and this make their job arduous and costly. But a technology was introduced—the Peach's Integrated –AML-Compliance Solution software which reduces the cost and work of finance directors with the results are credible, useful, and multi-purpose.

(Abrahami 2008)