

Keynote speech

Audit Quality Symposium –

Canadian Public Accountability Board - Toronto

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Dear Ladies and Gentlemen,

It is a pleasure to be invited, in my capacity as chair of the European Securities and Markets Authority (ESMA), to deliver the keynote speech here in Toronto at the inaugural dinner of the Canadian Public Accountability Board's Second *Audit Quality Symposium*.

ESMA is a young organisation involved in a number of different fields, of which financial reporting and audit related issues are probably of most interest to you. However, before touching upon those I would like to introduce ESMA, our objectives as well as giving you a flavour of what has been high on our agenda over the last few months.

Today we are now more than five years away from the 2007 financial collapse and it seems as though financial supervisors, central banks and governments have been in a permanent state of crisis ever since. Europe especially has been getting a lot of bad press lately, and some Member



States have been criticised for endangering the euro and the resulting debate is now focusing on the governance of the euro area.

The crisis began when global financial markets came to a standstill due to a decline in the US housing market and its knock on effect on sub-prime mortgages, their linked CDOs, and the consequent losses that European and US banks accumulated, leading ultimately to the collapse of well-known banks like Bear Stearns, Lehman Brothers and, in Europe, Northern Rock. The financial system had to be rescued through bailouts at huge costs to European and US taxpayers causing economic recession in most parts of the world that has yet to abate. However, the crisis that Europe is experiencing today has little to do with the 2007 financial collapse but more with the resulting economic crisis and the governance architecture of the euro area. Though both crises are interlinked, I believe that we should differentiate between the financial crisis and the subsequent economic crisis with its devastating social impact. As a financial markets regulator I will not touch upon that but will focus on the regulatory reform initiated as a response to the financial crisis.

Indeed, the crisis triggered enhanced co-operation at the G20 level and led to a myriad of policy decisions aimed at reforming the world's financial system. The pace of reform has been steady in the European Union (EU) and at least as far ranging as in the United States (US) and in many other parts of the world. Though there is a clear need for better regulation, and we fully support these initiatives, I think we should not create the impression that we can legislate for every possible scenario. Perhaps more



than legislative changes we need the financial industry to develop a different mind-set.

In Europe, the crisis initially triggered a wider review and reform of governance. A new pan-European supervisory model, including ESMA, was established in 2011 as a response to the financial crisis. The reliance on a supervisory model that was centred on the national supervisors of its 27 Member States had not proved to be as effective as thought possible for three reasons.

The first reason relates to what we call today ‘systemic risk’. Although there were some initiatives by the European Central Bank (ECB) to assess the risks to the financial stability, from a euro-wide perspective as part of its *Financial Stability Review*, there was a clear lack of structure to monitor, control and manage the risks to the financial system on a pan-European basis.

The second and third reason relate to the structure of the European Union’s Single Market and how financial regulation is developed and subsequently supervised, especially for cross-border groups.

The European Union, similar Canada with its ten provinces and three territories, is a union made up of distinct jurisdictions with their own identities, legal structures and traditions – although the EU far outstrips Canada in its number of official languages with 23. In order to achieve European integration, the EU made extensive use until recently of what we call *minimum harmonisation*, that is to say that legislation is developed as a



threshold that Member States should meet whilst allowing them to go further than the EU approach.

The third reason was the shortcomings in cross-border supervision, which links closely to the lack of a single set of rules across the EU. Whilst financial institutions expanded their activities massively in other countries (within but also outside the European Union), a lot of reliance was put on the judgements and decisions of the home country supervisors without sufficient co-operation or dialogue.

It is clear that the lack of what we call today a *single rulebook* and supervisory convergence formed a dangerous cocktail if certain Member States decide to adopt a less strict approach to financial regulation and less stringent supervision to attract business. If such a gamble turns out badly and leads to bailouts of financial institutions, which in turn obliges governments to seek help from other EU Member States, it should not surprise anyone that these bailouts became highly contested, not least by taxpayers.

Therefore the European Commission (EC) tasked a high-level Group chaired by Jacques de Larosiere (former IMF Managing Director and Governor of the Banque de France) to formulate recommendations on how to strengthen the European supervisory system. In its final report, the high-level Group, suggested reforms to the structure of financial supervision in the EU and consistent implementation of harmonised rules. Since then the set up and processes of financial regulation and supervision have changed significantly in the EU with the creation of:



- (i) a European Systemic Risk Board (ESRB) responsible for the macro-prudential oversight of the financial system within the Union;
- (ii) three European Supervisory Authorities: the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) becoming central pillars for maximum harmonisation and moving away from the principles of minimum harmonisation;
- (iii) Certain aspects of the supervision of cross-border entities such as credit rating agencies, trade repositories, or market infrastructures have shifted to European supervision or supervisory colleges.

And so ESMA was established on 1 January 2011 with five priorities: financial stability and crisis management, creating a single EU rulebook, supervisory convergence, investor protection and the direct supervision of credit rating agencies.

Financial stability and crisis management

The three European Supervisory Authorities (EBA, EIOPA and ESMA) actively contribute to the work of the ESRB through the identification of emerging and systemic risk within their fields of expertise. ESMA has already undertaken risk assessments which have been discussed and shared between the different institutions. We have completed specific work on the risks associated with the current trends towards structured and complex retail products, the CDS market and the shadow banking system in Europe.



However, the aim is not to just prepare reports but to set appropriate policy responding to those trends and risks. ESMA now has a significant role to coordinate the activities of European national supervisors during *adverse market developments*, for example earlier this year in June/July when financial market conditions worsened significantly in the EU.

Single rulebook

As I said earlier a single market cannot function properly if national rules and regulations are significantly different from one Member State to another. It leads to competitive distortions among financial market participants and encourages regulatory arbitrage. ESMA has therefore been equipped with the responsibility of preparing and issuing technical standards. These are developed at the request of the lawmaker and are legally binding in all 27 member states. Guidelines can also be issued to market participants and national supervisors on ESMA's own initiative on the basis of a comply-or-explain principle.

Much of ESMA's work is being conducted in the context of international agreements on the reform of the financial markets. These agreements are the so-called G20 commitments and they have been essential in achieving, as much as possible, comparable regulatory reforms across the various financial markets. This worldwide coordination is obviously very important considering the interconnectedness of financial markets and the risk of regulatory arbitrage.

In the past year we have developed 51 draft regulatory and implementing standards and six sets of guidelines in areas such as credit rating agencies,



short selling, high frequency trading, and alternative investment funds. I specifically want to mention the 40 recently completed technical standards developed to meet the EU commitment to have rules in place for derivatives market by January 2013.

But an accounting issue is also part of the G20 commitments: the desire to achieve global accounting standards and I will discuss this topic in more detail later on.

Supervisory convergence

We cannot rest on our laurels after developing a single set of financial regulation across the EU or at international level. Regulation should also be applied and supervised consistently within a single market. Or to say it with the words of Tommaso Padoa-Schioppa – the founder of FESCO, one of the predecessor bodies of ESMA – “cross-border supervisory cooperation should be so strong and effective that the collective behaviour of supervisors would appear as a single one”.

To ensure the effective implementation of the single rulebook, and again, to avoid regulatory arbitrage, ESMA supports supervisory convergence by addressing national supervisors through guidelines or opinions. We have set out our views on several occasions. For example, in the accounting area we issued an opinion last year on the valuation of sovereign debt in IFRS financial statements. We also actively support supervisory colleges, like the upcoming colleges to supervise central clearing parties (CCPs).



Let me also mention that as result of the LIBOR and Euribor cases, ESMA is conducting a number of activities related to reference rate issues. Together with the European Banking Authority, we are conducting a review of the Euribor system, covering the rate setting system and the submission process. Secondly, guidance is being developed for benchmark providers and market participants focusing on transparency, conflicts of interests and controls. This work compliments and contributes to the forthcoming European Commission work in this area.

Investor Protection

ESMA has reinforced the European framework for investor protection through a series of concrete initiatives. In July 2012, ESMA published two sets of guidelines aimed at enhancing the protection of investors and financial consumers more broadly. One set concerns the suitability of advice to financial consumers and the other set concerns investment firm's requirements regarding the compliance function.

Also in July, we published guidelines on ETFs which are aimed at strengthening investor protection and harmonising regulatory practices across this important EU fund sector, through increasing the level and the quality of information provided by ETFs to their investors.

After the summer we have published draft guidelines for consultation which address the alignment of remuneration with the overarching obligation on investment firms to act honestly, fairly and professionally in accordance with the best interests of its clients.



We apply the term ‘investor’ very broad. We are nearly all investors and so is the retired aunt or uncle around the family dinner table. All too often we are stuck in our jargon whilst the money of those who do not understand our messages, or are blithely unaware of our existence, might be exposed to high risk products. We therefore pay specific attention to the role of, and communication with, retail investors, and have recently published a guide to investing and a warning on the risks of using the internet for investment purposes.

CRA supervision

The supervision of credit rating agencies is an area where ESMA has direct supervisory powers. Currently 18 CRAs have been registered and ESMA continues to receive further applications for registrations. In executing our supervisory responsibilities, ESMA’s CRA Unit has undertaken two on-site inspections at the three largest registered entities. The first inspections were conducted in December 2011 and the findings were published last March, while a second round of on-site inspections has been completed after summer. The March 2012 report identified several shortcomings and areas for improvement for CRAs such as on the transparency of rating methodologies, the adequacy of rating methodologies and recording internal processes, which we are addressing through our supervisory activities. We are now examining the findings of our most recent inspections in preparation of our supervisory findings on the basis of the second round of inspections on bank rating methodologies.

Financial reporting



I have promised to talk about issues that are closer to the theme of your meeting: financial reporting and audit, and now it is time for me to deliver.

As you know the EU took the bold decision in 2002 to move towards International Financial Reporting Standards (IFRS). We have very positive experiences with IFRS as it enhanced both the quality and quantity of the information provided in the financial statements. I am pleased to be in a country that recently adopted IFRS.

Being here in Canada also gives me the opportunity to express my wish, without fear of too much barracking, that your close neighbour across Lake Ontario will move towards IFRS too. Although fully understanding the domestic and political constraints the US SEC faces, I am personally disappointed with their lack of action regarding IFRS. Patience has been a real virtue for us over the last few years and there have been a number of efforts to facilitate the adoption of IFRS in the United States. Some of those were difficult topics for the IASB's constituents to accept, especially in Europe, but we were willing to pay the price to get the US onboard. Today I believe that many people feel as I do, which is disappointment that there is no progress or clear sign of political will to keep IFRS adoption high on the agenda in the US. We have made so many far-reaching mutual decisions over the last years that it would be a shame to miss the opportunity by walking away from IFRS.

In any case, we should not accept that the lack of an American timetable for a decision and clear support for IFRS is slowing down the IASB's technical agenda. We urgently need to finalise the post-crisis agenda with projects

like impairment of financial assets and insurance contracts. Convergence can no longer drive so vividly the IASB's agenda and it is time that the Foundation and the IASB now focus their resources on setting high quality accounting standards and the important challenges it faces to achieve consistent application of IFRS.

Consistent Application of IFRS

Consistent application and enforcement of IFRS is essential to market integrity. Ensuring such consistency enables fair and efficient functioning markets and high quality information for investors. While the correct application of IFRS is the prime responsibility of issuers and their auditors, securities regulators can intervene when there are violations of IFRS in published financial statements.

ESMA coordinates the activities of national IFRS enforcers in Europe. Earlier this month we issued for the first time common European IFRS enforcement priorities. This is the first time all European enforcers have agreed on common enforcement priorities highlighting the areas on which all EU enforcers will focus when reviewing 2012's financial statements. I will not go into detail, and you will find the statement on our website, but our priorities relate mainly to the areas of:

- a) financial instruments;
- b) impairment of non-financial assets;
- c) defined benefit obligations; and

d) provisions that fall within the scope of IAS 37 – *Provisions, Contingent Liabilities and Contingent Assets*.

Those themes are also relevant outside of Europe, as consistent application is a challenge for all markets around the globe. We are therefore improving our liaison with other regulatory and enforcement bodies around the world, and with the international line-up of speakers at this meeting, I can see that Canada is clearly interested in hearing what others from around the world have to say. We hope it will form the basis for a further deepening of our international co-operation.

Our common enforcement priorities highlight the need for improved disclosures. Our emphasis on disclosures is not because we believe that disclosures could replace the recognition and measurement principles, but rather that it allows issuers to provide investors with high-quality information within a principles-based environment. We think that the IASB should set objective-based IFRSs (such as is currently the case with IFRS 7 – *Financial Instruments*) allowing a company's management to align it as best as possible to its own situation. However, a principles-based environment can only survive if clear and entity-specific disclosures, reassessed at the end of each reporting period, bring useful decision-making information to investors. If not, detailed prescriptive requirements would need to be developed and we all know that what is important today will not necessarily be so in the next financial year. The only way to avoid this is for issuers to stop providing boilerplate information directly mimicking the standards.

We purposely issued the common enforcement priorities before the year-end so that companies and their auditors could – and should – take due consideration of them when preparing and auditing the IFRS financial statements for the year ending 2012. Auditors have an important role to play in assuring investors about a company’s financial position and performance, which is more important than ever for all companies, and especially financial institutions.

Audit

This brings me to the current discussion on how audit issues fit within the broader regulatory reform agenda.

Like many other parties, auditors play an important role in fighting the current crisis. Some of you might not like to hear this, but we have to admit that there have been serious shortcomings in the performance of the auditing sector during the crisis and that we have to learn from that. Prior to joining ESMA, as you may know, I was active in the regulation and supervision of auditors. During my time as chair of the International Forum of Independent Audit Regulators (IFIAR), I was extensively involved in the exchange of experiences about national inspections regarding audits of issuers hit by the financial crisis. One result of this work that struck me was that many of the shortcomings identified do not relate to auditors being unable to handle complex issues, rather they relate to quite basic auditing issues. These include a failure to give sufficient attention to issues whether in terms of time, or a failure to escalate them to a sufficiently senior level within the audit firm.

As regulators we also saw that it took some time before the valuation of, and disclosure on, complex financial instruments traded in illiquid markets improved and met the right standards. I am personally convinced that if auditors had done a better job, investors would have had higher quality information on these financial instruments at an earlier stage and could have acted accordingly.

A relevant current issue in this context concerns forbearance, or the situation where a borrower is in financial difficulties and does not pay on time, and the lender decides to wait and see, perhaps he even renegotiates the arrangement on more favourable terms. I believe that it is important for lenders to clearly reflect in their financial statements the credit risk they are exposed to in relation to forbearance. They should do this by providing clear disclosures that helps investors to understand the extent of the forbearance practices when the exposure is material and to evaluate the need for potential impairments. It is needless to say that I believe this is of relevance for the auditors and not only for the management of the issuers.

There are also other areas where auditors should further improve. The audit report could for example be made more relevant for the investor than the current one-sentence-approach saying that the financial statements reflect a true and fair view of the financial positions and performance of the company. We believe that auditors should continue to do so but that it should be supplemented by clearly communicating the auditor's view on specific items in the financial statements as well as the audit process undertaken when the opinion is qualified or when there is an emphasis of



matter. As touched upon earlier when discussing our common enforcement priorities, IFRSs are principles based standards and rely significantly on management's judgment. We believe that the auditor should assess and report its views on management's key assumptions such as on goodwill impairment or valuations of financial instruments.

Audit supervision

But not only should the audit profession improve. It is important to supplement those improvements with the regulation and supervision of auditors.

Following the introduction of audit supervision in 2006, the EC now proposes to strengthen supervision in the EU, and to further improve the single market with harmonised standards, by for example requiring ESMA to issue guidance on issues like conducting audit quality assurance reviews. In the current European Commission proposals, ESMA is not going to supervise auditors directly; the competence for supervision remains with national oversight bodies who have a close understanding of the local market and its drivers. The knowledge and the good practices developed by some national regulators are an important cornerstone to build a stronger and harmonised European supervisory framework.

We need to be much more ambitious regarding international and European cooperation in audit oversight. At present there is a large gap between the level of cooperation and integration of auditing regulators compared with that of the international networks of audit firms that regulators need to

oversee. A failure to increase the level of international and European cooperation is a substantial risk for the effectiveness of auditing oversight.

In the audit sector the group of largest networks is nearly identical in every country and continent, with day-to-day national auditing practices being strongly influenced by the regional and worldwide management of the international audit firms. Serious extra-territorial issues are inherent in the oversight of internationally active audit firms. Therefore, there is a need for a more consistent European approach to overseeing the sector and for more international cooperation. This particularly holds for the larger international audit firm networks, some of which have established legal entities covering their activities in different countries.

The Commission proposals are currently being debated. Whatever direction the negotiations will take, the EU has to make sure that whichever system of oversight it develops it should be able to cope with audit firm's practices: more co-operative, more European, more international.

Ladies and gentlemen, thank you very much for your attention.