EVENT REPORT

The EU financial reform agenda has focused on the need to stabilise the financial system. In doing so, fundamental questions have been raised about the roles of various actors; including banks, hedge funds, supervisors, credit rating agencies and auditors. A common thread in the EU policy response has been that of taking action to ensure the real and perceived independence of financial services actors. In particular, recent or forthcoming legislative proposals regarding auditors, credit rating agencies and securities markets set down measures to avoid conflicts of interest and ensure independence:

- What is the purpose of independence? Is it an end in itself or a means to an end?
- How can "independence" be assured and demonstrated in financial services industries?
- Are conflicts of interest unavoidable? What measures to manage them can be applied? Is regulation the best way to tackle conflicts of interest?
- How is a professional self-awareness and scepticism versus clients ensured?
- What role for codes of behaviour? Are they the best means of ensuring professional judgement or a smokescreen to allow what is most profitable?
- What lessons can be learnt from other sectors?

KEYNOTE SPEECH

Steven Maijoor, Chairman, European Securities and Markets Authority (ESMA)

Speaking at CEPS-ECMI on «independence in financial services», ESMA Chair Steven Maijoor highlighted the crucial importance of independence in the provision of financial services, with reference in particular to the audit profession, credit rating agencies and the provision of investment advice – three topics featuring high in the EU regulatory agenda. The following paragraphs are recollections from his speech:

Independence is at the heart of quality services in financial markets. Conversely, the lack of independence has resulted in prominent market failures and scandals. Thinking of Parmalat, WorldCom and other similar cases, the objective failures in accounting and auditing were not so much due to the complexity of the particular auditing task but rather to the lack of independence of service providers.

Economic theory preaches that market discipline will ultimately punish those players who fail to perform their tasks appropriately due to conflicts of interest and lack of independence. But in financial markets, market discipline does not work since the present benefits of non-independent behaviour tend to outsize the expected future penalties. Complexity and asymmetries of information also mean that non-independent behaviour in financial markets is more difficult to identify and tackle.

Regulation and supervision can correct some failures but cannot micro-manage service providers. In effect, ordinary supervision cannot address fundamentally flawed business models –that is a question that would require a more fundamental review.

Liability is an important mechanism to discipline service providers by enabling clients to uphold their rights. While avoiding reckless behaviour by clients and minimising unmeritorious claims, regulation should set a fair standard of liability for service providers. For instance, a liability regime is needed for credit rating agencies who fail to follow an approved rating process or whose behaviour is motivated by a conflict of interest, to the detriment of investors.

The regulation of CRAs in the European Union has placed these entities under supervision for the first time, which is a welcomed step, enabling supervisory action to uphold independence. Measures such as the rotation of analysts were devised precisely with independence in mind. But more action is needed in several respects, including in addressing the conflicts of interest between the owners of credit rating agencies and the agencies themselves, as highlighted by recent news stories.

Mr. Maijoor, having a long-standing experience in audit supervision, considered that the insufficient independence of auditors versus management is of great concern and makes the forthcoming EU rules of crucial importance. Lack of sufficient attention by auditors to certain respects may well be explained by a lack of sufficient independence. Moreover, while auditors are responsible of communicating certain situations to supervisors and prudential regulators, these mechanisms simply do not work in practice, as highlighted in a recent report by the Bank of England. Good audit has a clear link with financial stability as witnessed over the years; in fact, the financial sector represents a prime source of income for audit firms.

Investment advice is another area where more independence of service providers is needed to ensure the interests of clients prevail. There is simply too much evidence of misseling and poor practices. Disclosure of inducements is important but not enough so banning inducements for «independent advisers» is needed. Some countries such as the UK and the Netherlands would even favour a complete ban of inducements to best protect retail investors. The argument that smaller retail investors may not get any advice is not credible, since investors are anyway paying for advice. Banning inducements may have the additional benefit of moving investors into less complex products.

Note: The views expressed by Mr. Maijoor at this CEPS-ECMI event are his own expert views and do not necessarily reflect the views of the college of supervisors. The notes above are a set of recollections from his speech and not a transcription.

PANEL DISCUSSION

In the following panel discussion, **Wolf Klinz** (MEP, ALDE) observed that independence is an essential characteristic of the liberal professions, going to the root of the services they offer. With regard to credit rating agencies and audit firms, Mr. Klinz considered that significant failures by both justify more stringent regulation. However, the proposed rotation of firms may reduce the quality of the service delivered and increase the power of clients to excerpt pressure upon service providers. It may be more effective at the level of the senior auditor than at the level of the firm. Limiting the additional services provided by audit firms is of crucial importance so as to reduce the weight of the income provided by a single client.

With respect to investment advice, Mr. Klinz considered that advice is in any case paid for by investors but that most of them are not aware of this fact. A major step forward would be therefore to implement clear disclosure that would tell to the investor exactly what part of their money is paid to the distributor and for which purpose. However, complete independence cannot be achieved in practice so the emphasis should be placed on minimising the conflicts of interest.

Fabrice Demarigny (Head of Capital Markets, Mazars) explained that credit rating agencies have acted with different degrees of independence in different market segments. For instance, in corporate bond markets ratings are very helpful but one may argue that pressures to correct the errors of the past have led rating agencies to behave aggressively in sovereign bond markets, in order to portray their absolute independence.

Demarigny also observed that enforcing independence across different business lines may reduce the profitability of some business models and leave some areas of the market, such as midcap markets, subserviced or not serviced at all, with detrimental consequences for the economy as a whole –calling therefore for some exceptions.

The number of service providers is also most relevant to their independence vis a vis clients and in this respect oligopolies represent serious risks. Moreover, in some market segments, there is absolute dominance of some players – take for instance the auditing of banks in certain member states.

Demarigny stressed that in order to foster independence in audit there is no single solution and that one must look at an appropriate policy mix, including for instance joint audits and tendering for audits that would allow a smooth transition between different service providers over time and probably result in a much more dynamic market place, thereby increasing the independence of firms with respect to their clients and the quality of audit.

Tony Bromell (Head of Integrity & Markets, ICAEW) stressed that independence is central to audit but is not an end in itself –rather a means to achieve the necessary objectivity in the professional analysis carried-out by auditors. The debate on independence with regard to audit is a long-standing one, with strongly held but differing views on what could be done and what the consequences might be. It is important to understand what is the actual problem causing mistrust –is it a relationship conflict, a pricing incentive conflict? Does it reflect a lack of monitoring and enforcement, bad training or a lack of knowledge?

Mr. Bromell noted that many things get confused with independence, for instance trust and objectivity. But they are not the same thing. Trust is about confidence in someone, which depends on a whole set of factors, including one's past record. Objectivity is a state of mind –not allowing extraneous factors to influence one's judgment and that is essential in terms of contributing to quality. Independence is about not having, or at least safeguarding against, the sort of relationships that might compromise objectivity.

Concentrating on the fundamental issues, would also lead to more attention being paid to how to improve training, develop better skills and ensure fitness for purpose. In the specific case of audit, it should also encourage a constructive debate on the usefulness of the audit opinion and how it could evolve in the future.

Donato Masciandaro (Chair in Economics of Financial Regulation, Bocconi University) reviewed the importance of ratings but also some its failures. Mr. Masciandaro stressed the deficiencies of the recent EU rules on rating agencies, which fail to address questions such as the business model of agencies (issuer pays versus investor pays principle) and the timing of communications. Mr. Masciandaro stressed the importance of eliminating the certification effect of regulation onto the ratings produced by private agents. The presentation is available for download through the ECMI website.

MORE INFORMATION

www.eurocapitalmarkets.org/independence

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Mirzha de Manuel