

# What can we learn from the EU about global convergence of financial regulation?

**Christian Leuz**

J. Sondheimer Professor of Intl. Economics, Finance and Accounting



The University of Chicago Booth School of Business

# Big Picture Questions

- A question mentioned in the conference theme
  - Can a “global culture” replace local cultures?
- Closely related issue: Global convergence of regulation
  - Harmonization of regulation in the EU to create a single market
  - Convergence of financial regulation is important part of G20 agenda
  - Arises in many areas: banking, corporate governance, securities regulation
- What evidence do we have on regulatory convergence?
  - I will talk about two examples closely related to my own research
  - Global accounting convergence through the introduction of International Financial Reporting Standards (IFRS)
  - Financial Services Action Plan and EU securities regulation
- Does a single regulatory regime lead to convergence?
  - What do we mean by convergence?
  - Rules or practices?

# Global Accounting Convergence

- Reporting standards is one of the areas of financial regulation in which we have made most progress
- Global convergence in reporting
  - EU requires IFRS reporting since Dec 2005
  - Well over 100 countries have either moved to IFRS or have decided to require IFRS in the near future
  - SEC proposed Roadmap to IFRS, which could lead to IFRS adoption in the U.S.
- Standards have been largely harmonized
  - IFRS are set to become the global accounting language

# Will we get convergence of global reporting practices?

- One answer is that it is just a matter of time
  - It takes time for firms to adjust their reporting practices
  - Significant learning involved
- In my mind, however, convergence is not assured
  - Implementation and enforcement of standards likely differ around the world
  - Firms' incentives to apply the standards and to report their financials differ widely around the world
- Many other institutions have not been harmonized in the same way
- My prediction is that reporting practices will not converge as expected

# What is the issue?

- Reporting incentives play an important role for reporting practices
  - Standards provide plenty of discretion, so incentives are likely to “fill the gaps”
  - Note that this is not just a matter of enforcement
  - There is lots of empirical research supporting this notion
- You might say that as long as standards are converged we should have an acceptable level of discretion and hence heterogeneity in practices
  - We do not have much evidence on this conjecture
  - Is within-country heterogeneity in practices smaller than across country-variation among global players?
- Implementation and supporting infrastructure matter as well
  - Enforcement is typically local
- If convergence is the goal, we also need to focus on:
  - Countries' institutional infrastructures
  - Differences in capital markets and the incentives they create
  - Differences in corporate governance and ownership structures

# Some Evidence

- Persistence in reporting practices
  - Relatively little direct evidence
  - Leuz (2010) reports rank correlations between the Leuz et al. (2003) earnings management and opacity scores across time
    - From 1986 to 1995 and 1996 to 2005 is 0.73
    - From 1990 to 1999 and 2000 to 2005 is 0.87
    - Nine out of top 10 countries in 2000 are still in top 10 by 2005
- Substantial heterogeneity in the capital-market effects around IFRS mandate
  - Effects are stronger in the EU than in the rest of the world
  - Effects are stronger in countries with stronger legal systems and better reporting quality in the past
  - Cross-sectional results point to the critical role of enforcement and reporting incentives

# New Evidence: Christensen, Hail and Leuz (2012)

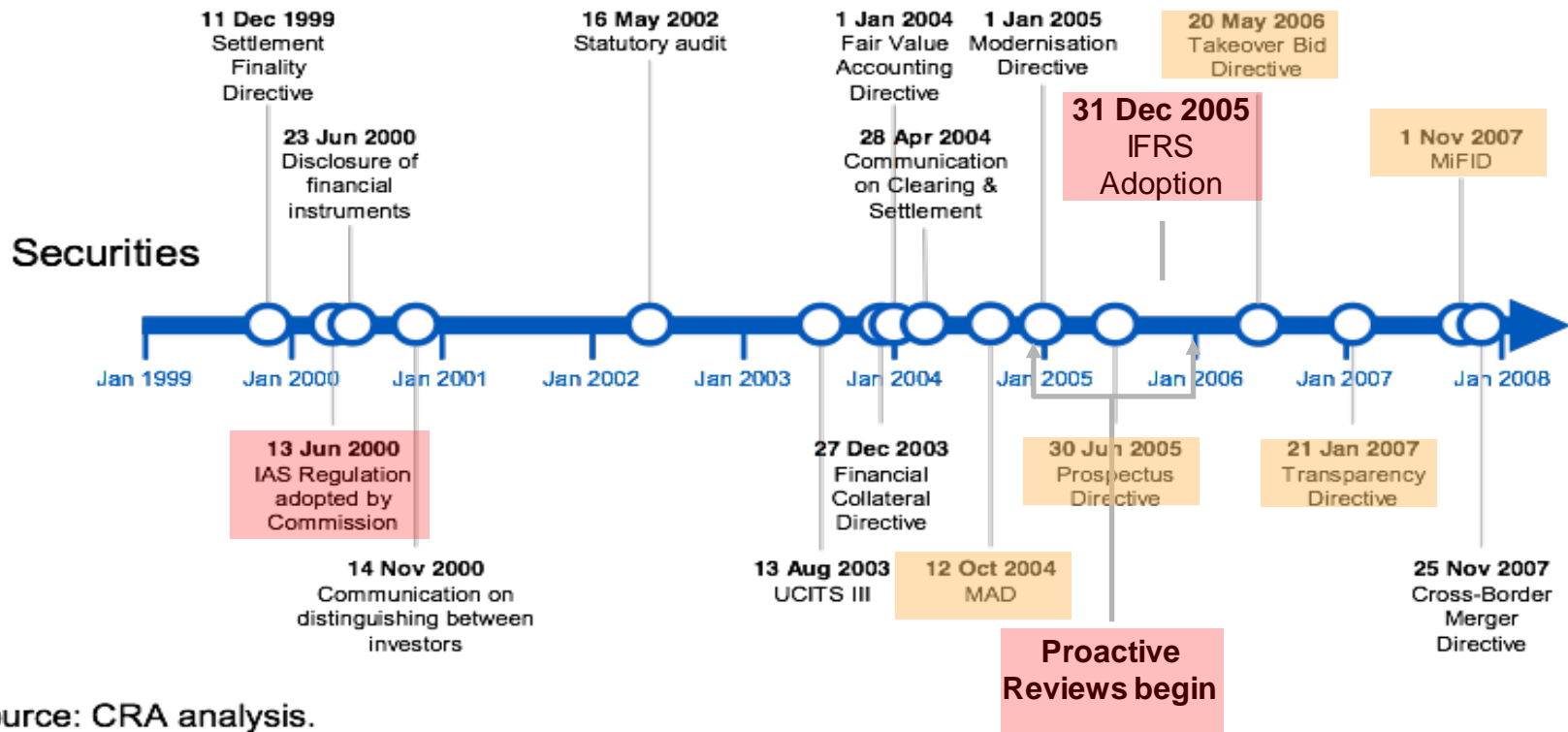
- Common interpretation of existing evidence
  - IFRS had capital-market benefits but only in countries with strong institutions and legal systems
  - Basic idea is that countries with strong institutions likely implement and enforce IFRS well
- But have we ruled out alternative explanations?
  - Contemporaneous economic shocks given that IFRS was introduced in many countries around the same time
  - Concurrent regulatory changes could line up with IFRS mandate in time and switch to IFRS reporting itself could have had little effect
  - Countries may make concurrent changes to supporting infrastructure when they introduce IFRS (e.g., IFRS and enforcement changes could be bundled)

## EU is an interesting case

- EU passed a series of directives to improve financial market regulation
  - Financial Services Action Plan in 1999
  - Market-Abuse Directive (MAD), Transparency Directive (TPD), etc. around IFRS mandate
- IAS Regulation, which introduces IFRS in the EU specifically requires adequate enforcement
  - But EU states had significant latitude in how to enforce compliance with IFRS
  - Several EU countries made supporting changes
    - Created new enforcement bodies
    - Introduced “proactive reviews” of financial statements



# EU Setting Around IFRS Adoption (Financial Service Action Plan, FSAP)



Source: CRA analysis.

# Enforcement Changes in five EU Countries

- Five countries “bundle” IFRS adoption and changes in enforcement
- Switch from reactive to “proactive” approach:
  - Enforcement body reviews at its own initiative using sample- or risk-based methods
  - **U.K.** reviews 260 firms/year (15% of firms) and finds errors in 36% in 2006/07 leading to restatements
- Create a new regulatory body and introduce proactive reviews:
  - **Germany** reviews about 130 firms/year (15% of firms) and finds errors in 23% of the cases (Ernstberger et al. 2011)
  - **Norway** reviewed 35 firms in 2006 (>10% of firms) and 13 were subjected to closer scrutiny
  - **Netherlands** reviewed around 30 firms in 2005 and 2006 (voluntary element until 2006)
  - **Finland** began reviews in 2005. Sanctions include restatements, public disclosures, and public warnings in 2006/07
- Significant shift in all five countries
  - We confirm this shift with a survey of national regulators and technical partners at PwC

# Research Design

- We study liquidity effects around IFRS mandate
  - Quarterly data from 2001 to 2009
  - Bid ask spreads and zero returns
  - Account for concurrent regulatory and changes in financial reporting enforcement
- Use variation in fiscal year ends because introduction of mandatory IFRS reporting depends on fiscal year end
  - Firm with Dec FYE reports in first quarter 2006
  - Firm with June FYE reports in third quarter 2006
- Can use separate fixed effects for each quarter (Q1 2001, Q2, 2001, etc.)
  - Capture time trends and worldwide changes
  - Separate trend for EU, non-EU IFRS, and non-treatment countries
  - Some tests with country-year-quarter fixed effects (within-country estimation)
- Other regulatory changes in EU (e.g., MAD, TPD, MIFID, etc.)
  - Kick in at the same time for all firms in a given country

## What do we learn from these results?

- Results are difficult to reconcile with notion that IFRS mandate alone had major capital-market effects
- Effects around the IFRS mandate are concentrated in five countries (not even in all of the EU)
- Concurrent enforcement changes (i.e., introduction of proactive reviews) can explain liquidity changes
  - Enforcement changes play a major role for liquidity effects
  - However, we cannot rule out that IFRS play some a role
- Study suggests that we need to revisit prior work
  - Important to worry about concurrent institutional changes

# Effects of EU Securities Regulation: Christensen, Hail and Leuz (2011)

- EU passed a series of directives to harmonize & improve capital-market regulation
  - Directives are part of European Commission's "Financial Services Action Plan"
  - Market Abuse Directive (MAD) & Transparency Directive (TPD)
- There were prior rules banning insider trading and mandating financial disclosure
  - MAD and TPD primarily aimed at improving implementation and enforcement of securities regulation
- Directives mandate changes to the supervisory structure and enforcement
  - Many countries gave additional supervisory and investigative powers to authority in charge of enforcing insider trading regulation
- Directives apply to all EU member states
  - Rules are harmonized
  - Supervision is local  $\Rightarrow$  EU cannot set the penalties or determine budgets
- Setting allows us to exploit differences in prior regulation, implementation and enforcement
  - Typically, the effects of rules, implementation and enforcement are a bundle

# Catching Up or Persistence?

- What happens across countries when directives are implemented?
- **One hypothesis: Countries with weaker prior securities regulation experience bigger effects**
  - Weaker EU countries are “catching up” with stronger countries
  - Basic idea behind harmonization
- **Alternative hypothesis: Persistence or Hysteresis in regulation**
  - Institutional fit and importance of the directives is different across countries
  - New directives face the same constraints as past securities regulation (e.g., political resistance)
  - Regulation is more effective in countries with better institutions, more efficient bureaucracies and a greater ability to implement and enforce policies
  - Past track record on (securities) regulation is likely informative about the ability and will to enact and enforce policies that induce or curb certain policies
- Alternative implies that directives could lead to more divergence, not less

# Research Design

- Examine capital market benefits of two EU directives
  - Focus on market liquidity
  - Market liquidity (and cost of capital) are often used as a justification for securities regulation
- Market liquidity has two desirable features for identification
  - It can be measured over relatively short time periods (use quarterly data)
  - It is less anticipatory in nature – concerns about adverse selection matter (most) when investors actually trade
- EU Directives were implemented at different points in time
  - EU passes the regulation (same for all countries)
  - Member states are given a fixed window to implement the new directive (2-3 years max)
  - EU countries need to pass legislation to implement the directives
- Setting provides limited discretion as to the timing
  - Leads to some clustering of the implementation quarters
  - Tradeoff: Ideally, some variation in the dates but not too spread out

# Dates and Sample Size

Slide 16

<i>Country</i>	<i>Bid-Ask Spreads (N)</i>	<i>Zero Returns (N)</i>	<i>MAD Entry-into- Force Dates</i>	<i>TPD Entry-into- Force Dates</i>
Austria	1,336	1,562	Jan-05	Apr-07
Belgium	3,492	3,534	Sep-05	Sep-08
Bulgaria	310	312	Jan-07	Jan-07
Cyprus	1,305	3,018	Sep-05	Mar-08
Czech Republic	146	231	Feb-06	Aug-09
Denmark	4,993	5,109	Apr-05	Jun-07
Estonia	225	435	Mar-05	Dec-07
Finland	4,034	4,074	Jul-05	Feb-07
France	17,163	17,678	Jul-05	Dec-07
Germany	9,352	9,681	Oct-04	Jan-07
Greece	n.a.	9,582	Jul-05	Jul-07
Hungary	793	837	Jul-05	Dec-07
Iceland	81	86	Jul-05	Nov-07
Ireland	710	741	Jul-05	Jun-07
Italy	7,590	7,964	May-05	Apr-09
Latvia	342	355	Jul-05	Apr-07
Lithuania	560	1,122	Apr-04	Feb-07
Luxembourg	29	73	May-06	Jan-08
Malta	n.a.	360	Apr-05	Oct-07
The Netherlands	3,764	3,793	Oct-05	Jan-09
Norway	5,006	5,162	Sep-05	Jan-08
Poland	5,433	6,291	Oct-05	Mar-09
Portugal	1,416	1,458	Apr-06	Nov-07
Romania	368	1,323	Jan-07	Jan-07
Slovakia	79	98	Jan-05	May-07
Slovenia	383	977	Aug-04	Sep-07
Spain	3,366	3,649	Nov-05	Dec-07
Sweden	8,321	8,763	Jul-05	Jul-07
United Kingdom	21,750	22,274	Jul-05	Jan-07



**For detailed regression results see latest version of the paper**

# Differential Effects Across Countries

- Regulatory quality (Kaufman et al. 2009):
  - Captures perceptions of the ability of the government to formulate and implement sound policies and regulations
- Securities regulation staff prior to MAD and TPD (in 2003):
  - Resources committed to securities regulation
  - Same forces that limited securities regulation in the past are also likely to be at play for new directives
- Directive-specific proxies for implementation and enforcement
  - Maximum fines, Supervisory powers given, actions taken
  - Conducted a survey of auditors and securities regulators asking whether there has been a significant shift
  - CESR report evaluating a country's compliance with 21 enforcement principles

**For detailed regression results see latest version of the paper**

# What explains the heterogeneity in liquidity effects?

- Effectiveness of prior regulation
- Directive-specific evidence
  - Not all countries endow regulators with same powers
  - Some countries set lower penalties
  - Countries do not necessarily take actions
- Additional channel
  - Countries pass regulation but do not commit resources
  - Effects are larger in countries with larger staff levels
  - Effects are larger in countries with above median staff growth

# What do we learn from the results?

- Again, heterogeneity abound
  - Countries with a history of higher regulatory quality or stronger prior regimes experience larger effects
  - Directive-specific implementation is also associated with regulatory outcomes, but primarily in countries with stronger past track record
- Results are not consistent with notion of “catching up”
  - Stickiness or hysteresis in regulatory outcomes
- Imposing the same rules can make countries diverge more, rather than move closer together
  - Initial conditions matter

# Why is convergence so difficult?

- Regimes often change in response to financial crises and corporate scandals
  - Political processes play a major role
  - Political resistance and lobbying
- Institutional complementarities
  - Reporting regulation is one of many elements of institutional infrastructure
  - In well-functioning economies, these elements are likely to be designed so that they complement each other (institutional fit)
  - Changing one element can make the system or the economy worse off even if the element improves
  - Starting points and historical events matter for today's institutional infrastructures,
- Differences in resources and priorities
  - Different countries have different needs
  - Same regulation is implemented differently in different countries
- New rules are subject to the same forces as in the past
  - Harmonization may not be stable over time (e.g., likely for IFRS application)

# So is convergence hopeless?

- Not necessarily
  - It depends on our expectations
- True reporting convergence requires convergence in countries' institutional frameworks
  - Unlikely, in particular, with respect to legal enforcement
  - Not even clear whether this is desirable
- We need new approach to convergence
  - Focus on firms for which there is a strong demand for convergence
  - In the area of reporting: Global Player Segment (Leuz, 2010)
- Exploit selection
  - Offer regimes that allow firms to opt in
  - Offer choice to firms with similar incentives
- Allow more heterogeneity within countries to obtain more across firms

# Global Player Segment (GPS): Basic idea

- Voluntary participation to exploits self-selection and need for commitment
  - Firms are more likely to have strong reporting incentives in the first place
  - Segment should be attractive to firms with international shareholder base, that raise finance internationally, and operate in many countries
- Two additional mechanisms to improve reporting convergence
  - GPS firms need to be approved by administrating body (e.g., governance requirements)
  - GPS requirements and enforcement mechanisms improve reporting quality
- Segment is operated by an supranational body
  - IOSCO at the global level; ESMA at the EU level
  - New body operated by the IASC Foundation
- Private contracting solution that does not involve cross-listing
  - Segment does not create competition for existing exchanges
  - Firms can concentrate their liquidity and trading in one place and still be part of the segment



# Global Player Segment (GPS): Requirements

- GPS firms are required to use IFRS
- Filings and reporting are reviewed by GPS staff
  - Comment and review process
  - GPS staff can request additional information
- Firms have to satisfy additional disclosures in areas that are closely related to firms' reporting incentives
  - Ownership structure
  - Related-party transactions
  - Compensation practices
  - Internal controls and risk management

# Global Player Segment (GPS): Enforcement Mechanisms

- Firms have to use an approved GPS auditor
  - Registration with GPS to assure auditor is qualified
  - Notification requirements with GPS
- GPS posts enforcement actions against a firm
- GPS can drop a firm from the segment
- Membership agreement grants GPS the right to conduct on-site inspections in certain circumstances
- In addition, firms could be asked to post a monetary bond up front (e.g., escrow account)

# Global Player Segment (GPS): Financing

- Member firms pay an annual fee
  - Just having firms pay has obvious limitations
- Audit firms pay a fee to be approved GPS auditor
- Exchanges pay a fee as they benefit from GPS certification
- IASC Foundation could raise funds as the segment contributes to the reputation of IFRS
- Financial services firms that create products based on GPS firms (e.g., an index) pay royalty fees

# Concluding Thoughts

- Rules are easier to harmonize or to convergence than practices
  - This may explain why the focus has been on harmonizing rules
  - Little evidence that harmonization of accounting rules has worked
- Global rules need to be implemented locally
  - Implementation and enforcement are key for the success of regulation and may be more important than the rules
  - Would we be better off accepting some diverge in rules in return for stricter enforcement?
- Initial conditions matter
  - Past regulatory outcomes are endogenous, i.e., reflect forces in the country
  - Imposing the same rules can make countries diverge more if they interact with initial conditions
- Empirical evidence highlights the difficulties that regulatory reforms and global convergence face
  - Institutional differences and complementarities make widespread convergence unlikely in the foreseeable future

# CHICAGO BOOTH



The University of Chicago Booth School of Business