Operational Impediments to Effective Financial Regulation

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In this paper, we analyze fundamental tenets of financial regulation that must be in place to ensure that rules in fact achieve their specified intent. Without transparent, measurable and comparable criteria, rules cannot govern their desired targets, sanctions may well miss those guilty for violations and regulatory and financial-institution accountability will be, at best, difficult to discern. Indeed, rules that do not meet transparency, measurement and objective comparability criteria may create a regulatory-framework premised on "false science" – that is, a preponderance of complex rules without fundamental validation – and enforcement factors that distract policy-makers from emerging risks and lead financial institutions to view themselves as safe and sound despite serious vulnerabilities.

SUMMARY

OPERATIONAL IMPEDIMENTS TO FINANCIAL REGULATION

IMPEDIMENT	STATUS	IMPACT
Regulatory Coordination	• Growing divergence in global implementation of capital, liquidity, systemic-designation, activity and other key regulatory standards • U.S. regulatory action uncertain due to inter-agency disputes and difficulties finalizing rules where multiple agencies must issue a single rule and/or where separate agencies have jurisdiction over institutions engaged in the same business line governed by differing rules/enforcement standards	• Comparability between national regimes is difficult, creating "havens" and risk of regulatory arbitrage, competitive disadvantage for firms under robust regimes, undue barriers to entry • Inter-agency differences, jurisdictional overlaps/disputes create burden, complexity and uncertain accountability for both institutions and regulators
Supervisory Capacity/Resources	• New rules are increasingly complex, require extensive examination/validation by examiners, and most supervisors suffer personnel/resource shortages	• Lack of regulatory expertise may lead to inconsistent, incomplete application of new standards, creating unrecognized weaknesses/competitive differences/regulatory arbitrage opportunities • Resource shortages may be addressed through additional fees on financial institutions, heightening profit pressure, creating possible conflicts and charter choices based on cost, not appropriate regulatory venue
Extraterritorial Application of Law and Rule	• Unsettled throughout global/U.S. framework, although CFTC has proposed an approach for certain derivatives • Lack of treaty, other protocols that define the reach of national regimes beyond borders or to offshore parent companies	• Fragmented efforts at a global framework create barriers to entry, inefficient cross-border trade in financial services, uncertain prudential standards, unclear regulatory responsibility and legal risk for cross-border firms when home/host requirements conflict

IMPEDIMENT	STATUS	IMPACT
Cost-Benefit and Economic-Impact Analyses	• Not generally provided for in global rules and expressly mandated only for certain U.S. rulemakings, with U.S. cost-benefit/economic-impact consideration similarly sporadic • U.S. agency charged with overall industry data expertise not yet fully operational, hampering benefit analysis	• Lack of quantitative cost information makes benefit considerations (often qualitative) particularly difficult and may lead to final action on rules that prove surprisingly costly to implement in light of resulting benefits • Failure to assess cost/benefit impact for individual rules makes it more difficult to assess the cumulative impact of regulation and ways to alleviate duplicative cost, avoid confusing reporting/disclosures, and clearly assign regulatory responsibility for desired policy outcomes • Aggregate economic-impact analysis may not address critical sectors, and national considerations (e.g., community-bank issues that do not appear material but have substantive local-market impact)
Legal Entity Identifier (LEI)	• Set for implementation in Q1 2013 but procedures to assign identifiers remain inconsistent, incomplete	• Implementation of rules premised on knowing counterparties' exposures will be difficult without LEI • Lack of uniformity among national regimes may undermine goal of global market, possibly leading to varying information, protocols, and barriers to entry
Accounting Standards	• Efforts to harmonize global accounting standards appear to have broken down	• Varying accounting standards lead to inconsistent judgment and disclosures of key factors such as when a position is netted, how many assets are impaired and how much capital is held

IMPEDIMENT	STATUS	IMPACT
Credit-Risk Assessment Criteria	• Global rules rely on credit ratings while U.S. law bars doing so	• Varying credit-risk standards create wide divergence in U.S. vs. global capital requirements • Alternatives in use to date may not fully reflect credit risk and/or be objective and transparent • Continued ratings reliance outside the U.S. poses potential systemic risk despite efforts to reform the ratings process
Transparency	• Inconsistent accounting, extensive disclosure standards based on varying regulatory criteria	• Market discipline resulting from clear reports that permit ready investor/regulatory risk judgment may be complicated, if not made impossible, by the increasing number of differing reports on similar criteria • Transparency to regulators undermined by uncertain treatment of confidential/proprietary information that may lead institutions to withhold information critical to effective supervision, cross-border resolution
Governance of Financial Conglomerates	• New global standards • Dodd-Frank imposes numerous requirements for financial holding companies, but leaves unclear how group-wide risk in other financial firms is addressed	• Lack of clear, consistent group-wide regulation can increase enterprise-wide or material business-unit risk, especially with regard to inter-affiliate and intra-group transactions • Varying global standards, differing regulatory regimes, uncertain confidentiality for supervisory information and gaps impede effective implementation

Table of Contents

Regulatory Coordination

Because of the range of activities conducted in financial institutions and the number of jurisdictions in which they operate, regulatory coordination will always be challenging. However, the array of recent rules and laudable attempts to craft them in a cohesive cross-border framework that cuts across all types of large financial institutions under all circumstances has made consistent, clear, enforceable standards even more challenging, yet no less essential.

Examples of recent problems in this area include:

- **Basel III Capital Standards**: This framework was finalized in 2010. Since then, few major-market national regimes have implemented the standards and pending plans to do so (e.g., in the U.S., European Union) include wide divergences that may make the global framework, at best, an umbrella over substantively different capital rules with varying prudential and competitive implications. A critical case in point is substantial differences in national practice setting risk weightings for various asset classes, a critical feature of the denominator in the ratio on which capital adequacy is assessed. Further, the Basel III rules permit measurement of key predicates – e.g., what qualifies as "capital" – under varying accounting and legal regimes, conceding so much to national discretion as often to render difficult effective cross-border comparison. The pending U.S. notices of proposed rulemaking (NPR) to implement the Basel III capital standards depart in significant respects from the global accord in areas such as how capital is defined, how much a bank must hold, applicable sanctions when capital falls below a "well-capitalized" threshold, and how risk-weighting judgments are to be made in the absence of reliance on credit rating agencies (CRAs).

- **Basel III Liquidity Rules:** This global accord was also finalized at year-end 2010, although many aspects of it remain uncertain pending an observation period that was to end by 2013. The Basel Committee may significantly revise the rules by year-end 2012 and no major national regime has yet implemented even an initial version of the global rules and pending proposals vary dramatically on key criteria. As with the capital rules, these criteria are often predicates for assessing actual safety and soundness – for example, which assets are "highly-liquid, unencumbered" ones so that they may be counted as safeguards against liquidity risk. Differing national conditions – e.g., the need to delete CRA references and the importance in the U.S. of GSEs – make many aspects of the global rules difficult to apply without unintended effects. The U.S. has, however, issued high-level, inter-agency liquidity-risk standards that have created a uniform set of expectations for banking organizations and the Federal Reserve Board has begun to craft a sophisticated method for tracking liquidity risk within the U.S. These are, however, not always consistent with global requirements and/or those of foreign bank home-country regulators.

- **Volcker Rule**: This U.S. rule must be issued by five regulators, the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), although some aspects of the rule (e.g., its effective date) lie solely within the purview of the FRB and others fall within a single agency's jurisdiction depending on the nature of the proprietary-trading or investment activity. Conflicting perspectives, overlapping jurisdictions and the complexity of setting standards here that comport with each of these varying regulatory regimes has slowed rulemaking and may well make the resulting standard most difficult to implement in a coherent fashion in the U.S., let alone with regard to offshore activities by U.S. banking organizations. No comparable standard applies outside the U.S.

- **Creditworthiness Criteria**: To date, the U.S. is unique in its requirement that financial regulation use other measures of creditworthiness than CRA ratings. This, as noted, has made it still more difficult for the U.S. to comply with global capital and liquidity standards and poses serious implementation issues in a wide array of regulatory arenas. Within the U.S., new standards for judging credit risk without CRA-reliance use either scales designed for other purposes (e.g., with regard to sovereign risk) or judgment criteria (e.g., for securitizations) so complex as to render the standards difficult to compare across different assets and, in some cases, so punitive as to form an effective barrier to certain transaction structures that may not otherwise pose safety-and-soundness concerns.

- **Risk Retention**: The Dodd-Frank Act requires that four agencies – the FRB, FDIC, OCC and SEC – set an overall risk-retention framework so that securitizers and, perhaps, originators of loans retain a portion of risk when the loans are sold into the secondary market. Further complicating this framework is the requirement that two additional agencies – the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD) – issue the risk-retention rules specifically applicable to residential mortgages. Risk retention is required of all securitizers and/or originators regardless of regulatory regime, but many in this industry operate under widely-different capital and liquidity standards (see above) that result in significant differences in the implementation cost of the varying risk-retention methods across all of the asset classes covered by the Act. This framework is still further complicated by a different risk-retention regime mandated in the European Union, with these differences so significant that the International Organization of Securities Commissions is now in the midst of a study evaluating these variations and the degree to which they could undermine credit formation and/or safe and sound capital markets.

- **Derivatives**: Wide differences in the regulatory standards governing OTC and other derivatives are evident both within the U.S. regime emerging under the Dodd-Frank Act and the global standards ordered by the G-20. Some of these relate to the uncertain extraterritorial treatment of rules in this area (see below). Others relate to possible drafting errors, for example the treatment of certain foreign banking Organizations in the United States with regard to the "Lincoln Amendment" statutory provision that requires separation between banking and derivatives operations that appear not to place US banks and the US branches of foreign banks on an equal footing. It is also unclear how the Dodd-Frank Act derivatives regime coordinates capital, margin and other standards for end-users with those for banks, with potential disparities creating incentives for transitioning derivatives activities to the "shadow" banks G-20 leaders and others fear may create the next round of systemic risk. A further major issue of possible conflict and unintended consequence results from the competing requirements intended to encourage a transfer of OTC-derivatives activities to central counterparties (CCPs). Pending capital requirements may well discourage banking organizations from using CCPs, making it unclear if this goal will be achieved for major OTC-market dealers and, thus, achievable throughout U.S. and global derivatives markets.

- **Systemic Designation**: The Dodd-Frank Act creates clear responsibility for systemic designation of nonbank financial companies, assigning this to the Financial Stability

Oversight Council (FSOC) and then requiring FRB regulation at the top level for designated firms. However, coordination thereafter breaks down due to the still-uncertain relationship between the FRB and the primary regulator of securities, insurance and other nonbank activities within a designated firm. To date, the relationship between the FRB as the top-tier regulator of bank holding companies (BHCs) and primary regulators for insured depositories and nonbank subsidiaries has often been contentious, with Dodd-Frank seeking to settle at least some disputes by giving the FRB more authority over nonbank subsidiaries. How these jurisdictional boundaries will be determined in SIFIs is unclear, as is how this will comport with nonbank firm obligations to customers (e.g., insurance policy holders). The relationship between this U.S. nonbank systemic-designation/regulation process and the uncertain, incomplete one in other nations also raises serious regulatory coordination concerns. Global designation standards are only partially proposed (i.e., for insurance companies) and nowhere near finalized.

Supervisory Capacity/Resources

As the rules discussed above make clear, U.S. and global regulators are struggling to finalize and implement many complex and conflicting standards. To do so effectively, they will need not only to address the significant operational impediment posed by incomplete coordination, but also to ensure agencies responsible for enforcing all of these rules have the leadership, skills and resources with which to do so.

Serious problems in this area include:

- **Leadership Uncertainty**: This occurs from time to time in all jurisdictions, but can be especially acute in the U.S., where the process of Presidential nomination and Senate confirmation for key regulators can lead to vacancies filled often for years by "acting" agency heads with unclear mandates for action, or particularly difficult or controversial ones (e.g., taking high-profile enforcement actions, finalizing controversial rules). As in all organizations, supervisory agencies often suffer serious morale and effectiveness issues while key leadership posts remain unfilled.

- **Training and Expertise Limitations**: This occurs in government agencies unable to attract and retain individuals with in-depth experience in financial models, risk-management operations, controls and systems in diversified and complex financial organizations or with needed expertise in emerging financial products and market trends that may present new risks. These personnel limitations may lead to rapid turn-over, inconsistent regulation and a focus on technicalities that can be easily judged in a "check-the-box" process instead of on emerging risks or meaningful non-compliance.

- **Assessments on Regulated Firms**: This can lead to charter selection based on least-cost regulation, not best in class supervision or standards that accurately reflect a firm's risk profile. When assessments or other agency resources (e.g., central-bank income) cannot be used to fund regulation, appeals to legislative bodies for funding increase the politicization of the financial-supervisory and enforcement process.

Extraterritorial Application of Law and Rule

Extraterritoriality (ET) defines the scope of law and rule that applies to activities conducted across national borders in different legal jurisdictions. Coordinating this in markets where treaties and other agreements seek to define ET, such as the European Union, is a complex undertaking despite statutory efforts to resolve it. It is even more daunting when cross-border operations occur outside trade agreements that expressly address ET. Global and regional trade agreements (e.g., those under the World Trade Organization and the North American Free Trade Agreement) seek to address fair trade in financial services, but often do so in vague terms and/or with uncertain dispute-resolution protocols.

Key issues here include:

- **Global Framework**: As noted, the Basel standards are intended to create a global prudential-regulatory framework that avoids regulatory arbitrage and undue competitive advantage for banking organizations. IOSCO and the International Association of Insurance Supervisors (IAIS) are similarly focused on this mission, but all of these efforts suffer from significant differences, incomplete implementation and wide grants of national discretion. As a result, the G-20 created the Financial Stability Board (FSB) as an over-arching governing body and, in June of 2012, gave it more specific authority not only to advise, but also to govern these agencies. More uniformity would avoid the disputes and disparities that result from national efforts to extend standards extraterritorially, but all of these cross-border standardization efforts are, at best, preliminary.

- **U.S. Person**: This definition is key to U.S. regulation as it defines the scope of direct ET regulation and indirect regulation when a foreign entity doing business in the U.S. does business also with U.S. persons abroad, even though affiliates or entities are not otherwise deemed U.S. persons. U.S. persons can be subject to competing legal jurisdictions, whether these are U.S. financial organizations operating in host countries that mandate standards even for branches within their borders and/or for foreign firms dealing with customers who may be both "U.S. persons" and subject to the jurisdiction of the firm's home-country regulator under standards different than those that may govern the person under U.S. law or rule. Regulators may intend ET to ensure best-in-class standards apply, but conflicting standards may still present significant legal and reputational risk to firms, as well as barriers to entry.

- **Swaps**: These derivative instruments pose particularly complex ET issues as they may be executed between counterparties in two countries, booked in a third country and risk managed under rules set in yet another. Because swap contracts are complex, long-term and are predicated on continuing payment streams, swaps-market participants often use a central-booking entity to risk-manage global exposures to their home-country. If legal coverage is differentiated by the rules governing swaps participants in as many as four national regulatory regimes, the efficiency of a central booking entity, its accountability to a clear regulator and senior management or a board in a single governing regime will be at best unclear. Conversely, many specific transaction issues – e.g., transaction-clearing standards – are specific to individual nations, so deference to these within the broad framework of parent requirements is required to ensure a global market. To date, swap-market standards to identify national regimes with appropriate prudential frameworks has not advanced to set clear standards guiding U.S. and other regulators as to which transaction rules should be respected, creating the potential for top-down regulation that may create regulatory-arbitrage, competitiveness and market-liquidity concerns.

- **Margin Requirements**: The CFTC's proposed treatment of margin requirements for uncleared transactions has raised significant ET concerns, especially by foreign supervisors. Because the CFTC is not part of the broader global effort to set capital standards, some argue that the margin requirements are incompatible with them and, thus, present serious operational and competitiveness concerns. This proposal, in concert with the swaps issues noted above, could lead foreign regulators to deny access to U.S. firms or refuse to provide certain information to the U.S. All of these disputes could also undermine G-20 efforts to create a harmonious global regime for OTC derivatives.

- **Foreign Banks in the U.S.**: The Dodd-Frank Act requires that foreign banks doing business in the U.S. do so here and in their home countries in accordance with U.S. prudential expectations. This is designed to ensure equitable and stringent regulatory treatment within the U.S. for all banking organizations doing business here, but the degree to which this criterion can in fact be used as a barrier to entry or requirement for subsidiary operations within the U.S. remains at best unclear. The Dodd-Frank Act requires that its systemic-regulatory and early-remediation standards apply to most foreign banks doing business in the U.S., but the FRB has deferred consideration of how to do so until it finalizes its pending systemic standards. Separate foreign-bank systemic standards could undermine the law's broader "level-playing-field" objective and create significant disparities in applicable rules within the U.S., as well as across the globe.

Cost-Benefit and Economic-Impact Analyses

Both cost-benefit and economic-impact analyses are critical to effective financial regulation, as each helps to ensure that parochial interests do not advance rules with undue burden or unanticipated macroeconomic implications. To date, both forms of regulatory analytics have been incompletely implemented. In the U.S., cost-benefit analytics is required only for a limited class of financial rules and is often conducted in a quantitative fashion that focuses on matters such as how much paperwork is required by a proposal, not on substantive matters such as macroeconomic risks, the amount of capital that may need to be raised, liquidity shortfalls that may result or costs firms may absorb if forced to restructure their operations. Similarly, "benefits" in these analyses are often judged in such broad and qualitative a way as to make external assessment similarly judgmental – for example, regulatory conclusions that a seemingly costly rule is offset by long-term benefits to economic stability cannot be well tested absent greater transparency about methodology and trade-off assumptions.

In general, global rules are not premised on transparent cost-benefit analyses, but several (e.g., the Basel III capital and liquidity standards) have been judged by quantitative impact surveys (QIS) that seek to assess net implementation cost. However, QIS methodology is not always revealed and conclusions are often based only on weighted-average data that, given the wide disparity in financial-industry composition and national disparities, make sectoral and national results difficult to assess.

In the U.S., two Executive Orders (EO12-866 and EO13-563) require that executive-branch agencies provide both economic and cost-benefit analyses for certain regulatory actions. However, these analyses are not required of independent agencies (e.g., the FRB, FDIC, SEC) and, when presented by agencies governed by the executive orders, are often done so with little detail as to make difficult objective judgment about the analytics that lead regulators to advance proposals to final standards.

Major barriers to cost-benefit and economic-impact analyses include:

- **Quantitative Focus**: To the extent these analyses proceed, they are often focused on specific factors that are relatively easy to measure (e.g., cost of filing reports) rather than more complex costs such as the potential adverse impact of a proposal (e.g., the Volcker Rule which is assessed for impact largely on paperwork costs without regard to market liquidity or similar effects). The economic-impact criteria vary widely in the U.S., although the over-arching review of these assessments by the Office of Management and Budget (OMB) can provide needed external judgment when OMB is actively engaged (again, sporadic). The varying requirements for these analytics, different quantitative factors used to judge them and differing models used by regulators to assess the same rule when inter-agency procedures are engaged can make these important analytics of less value than anticipated when Congress required them.

- **Transparency**: Because of these often complex and inconsistent methodologies, transparent disclosure would facilitate regulatory and external review of cost-benefit and economic-impact analyses. This is, however, again inconsistent. With regard to cost-benefit analysis, many recent actions indicate only that the agencies have determined costs to be "insignificant" or "minimal" without providing any justification as to this conclusion. This problem is also found with regard to economic-impact analyses, which similarly reach no-impact conclusions without elaboration or release. For example, HUD indicated that it had consulted with OMB and advised the agency that the risk-retention rule required for securitization (see above) posed no adverse economic impact concerns. However, no copy of the analysis underlying this contentious conclusion was released during the public-comment period despite the requirement that it be made public (at least in broad terms) and public requests for HUD to do so.

- **Scope of Review**: Because of the variation in required cost-benefit and economic-impact analyses, agencies can circumvent these under an array of circumstances. These include whether the agency determines that a rule is or is not "discretionary" or whether a substantive action is issued as a rule or guidance. If guidance, then cost-benefit analysis that would otherwise be clearly mandated may still not apply. Agencies may use this approach to speed up contentious actions they believe urgently needed, with the CFTC most recently adopting this tactic for the ET standards discussed above. However, without robust public comment, significant actions may well have unanticipated and perverse results or, at the least, be far more costly to implement than additional scrutiny would determine to be warranted.

- **Data Integrity and Reach**: Reflecting the critical importance of basing policy on meaningful, comparable data, the Dodd-Frank Act created the Office of Financial Research (OFR) within the Treasury Department and FSOC function. OFR is charged with several tasks, but a critical one is to determine which data elements are essential for effective prudential regulation and, then, to gather them in a uniform fashion across the industry. To date, this has not occurred, with OFR still in an initial phase despite the two years that have passed since enactment of the new law. The G-20 has urged the FSB to use its increased power to lead efforts to make cross-border data more uniform and useful, but these efforts again remain largely preliminary. Nevertheless, in the global arena as in the U.S., many consequential rules are being finalized even as regulators acknowledge that they lack essential data. A key example in the global arena is the capital surcharge for global systemically-important banks (G-SIBs). The final Basel Committee standards frankly acknowledge that much of the data needed to compare candidates for G-SIB status and key systemic-risk indicators remain largely incomplete. It did not, however, defer rulemaking while reliable data are developed.

- **Sum Total Cost-Benefit or Economic-Impact Analysis**: Many pending U.S. and global prudential rules are deeply intertwined with others (e.g., capital standards affect assets held to meet liquidity rules). However, to the extent cost-benefit and/or economic-impact analyses are conducted, these to date have often been in a "silo" fashion that focuses solely on an individual rule, not on its relationship to the broader range of related proposals. This makes it difficult to assess if a rule is even needed, as others may accomplish its goals or be readily modified to do so. It also significantly complicates benefit and impact analyses because desired objectives may be unachievable due to unanticipated conflict with other requirements. Recognizing the need for cumulative-impact analysis, the FDIC has convened a working group to assess this issue when it promulgates its rules, but it is unclear if any other prudential regulator has such a body and no conclusions of any such deliberations have been made public.

Legal Entity Identifier

An array of pending reform proposals and rules is premised on the importance of understanding which party to a transaction is at risk to whom and, then, to measuring these risks to prevent concentrated risk exposures or unanticipated correlations of risk to seemingly unrelated entities, sectors or geographies. Knowing counterparties is also critical to orderly resolution, with difficulties doing so in cases like Lehman Brothers compounding the gravity of the financial crisis and making clear the importance of this issue in the reforms now under way. Because many firms (including financial institutions) are complex and operate through an array of legal structures across numerous jurisdictions, designating the ultimate counterparty in a financial transaction has proven difficult.

Reflecting this, global regulators and the U.S. OFR have worked to create a legal-entity identifier (LEI) to facilitate counterparty tracking regardless of jurisdiction or other extraneous factors. At its June 2012 meeting, the G-20 announced a major advance in global agreements on the LEI, signaling that a functional system will be ready for use by March 2013. However, the emerging LEI may not prove to be the global, over-arching identifier originally anticipated.

As a result, it presents the following operational concerns:

- lack of global uniformity, which may undermine the critical cross-border goal of the LEI in a global financial-services market;
- uncertain implementation in national regimes, which may lead to varying information and/or barriers to entry;
- uncertain error-correction and validation protocols, which may limit long-term LEI utility;
- given the "federated" nature of the LEI as recently determined by the G-20, there may be a lack of clear audit and governance protocols to ensure comparable, uniform data; and
- inconsistent standards that may limit cross-border transparency and, thus, the ability to penetrate legal hierarchies to assign risk to the actual party ultimately responsible for it.

Accounting Standards

Standards that measure key components of a financial institution's balance sheet are critical to judgments about a firm's profitability, forward-looking prospects and safety and soundness. It is for this reason that securities law and investor demands require reporting on established accounting standards – Generally Accepted Accounting Principles (GAAP) in the U.S. and International Financial Reporting Standards (IFRS) in the global arena. However, IFRS are not generally adopted in key markets (e.g., Japan), leading to additional divergence in accounting standards. Recognizing that this divergence poses an array of prudential, market-integrity and competitiveness concerns, the G-20 has pushed for reconciliation, focusing principally on the need to harmonize GAAP and IFRS. Efforts to do so have been under way even before the financial crisis, but were made still more urgent in its wake due to fears that the overall framework of global financial regulation is undermined by lack of common accounting standards. Nevertheless, in mid-2012, the long, difficult harmonization effort appears to have ground to a halt.

This will perpetuate widely varying accounting standards, with the following implications for effective financial regulation:

- judgments as to when a risk is or is not netted remain at wide variance, making it difficult to impose uniform capital, margin and other critical requirements or judge true capital resilience;

- practice with regard to loan-loss reserves differs dramatically between IFRS and GAAP, meaning that U.S. standards make it more difficult for financial institutions to hold reserves against "expected" credit risk;

- criteria for designating an asset as "impaired" vary widely and thus create inconsistent reports as to the actual risk of an institution's holdings; and

- varying definitions of "equity" make designating instruments such as eligible capital inconsistent and may complicate regulatory and investor judgment on this key indicator.

Credit-Risk Assessment Criteria

Credit risk is a key criterion for both micro- and macro-prudential regulation. That is, reliable, objective and transparent judgments of credit risk are essential both to understanding an individual financial institution's safety and soundness and to assessing the degree to which increasing credit risk in a sector (e.g., mortgages) or a national economy may create a risk to financial stability. In the run-up to the financial crisis, credit-risk determinations by both institutions and regulators largely depended on the rankings provided by major credit rating agencies (CRAs). However, it is widely concluded that this reliance led to:

- lack of appropriate investor due diligence to validate credit risk;
- concentrated risk holdings at institutions and/or undue demand for certain assets across markets based on ratings; and
- "cliff effects" – that is, sudden realization of risk when ratings drop that leads to asset "firesales," significant hikes in margin requirements and other actions that may precipitate or worsen a financial crisis.

Despite general agreement on these findings, the global response to them has been incomplete and inconsistent. Although global regulators and those in some national jurisdictions (including the U.S.) are seeking various reforms to CRA procedures, regulation generally continues to rely on CRA determinations to set risk weightings for regulatory capital, determine liquid assets and make other fundamental judgments. In sharp contrast, the Dodd-Frank Act bars regulatory CRA references, a mandate that has led to an array of varying credit-risk judgment methodologies in U.S. capital standards, eligible-investment criteria and other prudential standards for banks, securities firms and mutual funds. Many questions remain about the U.S. CRA replacements and how these will comport with the global credit-risk framework's continued use of CRAs. Concerns here include:

- the manner in which risk weights are set for assets, with the U.S. methodology resulting in significant differences from global standards and, in some instances, considerably higher requirements;
- reliance on internal credit-risk judgment that may be subject to conflicts of interest and/or be difficult for regulators and investors to assess; and
- the degree to which CRA replacements in the U.S. in fact reflect real credit risk. For example, the new standards for judging credit risk related to sovereign obligations are based on ratings developed for another purpose that, U.S. regulators acknowledge, may not be a forward-looking, reliable methodology for obligations that form a very important potential risk for most institutions.

Transparency

The Basel regulatory framework is predicated on three “pillars”: capital, supervision and market discipline, with the latter expected to result from a raft of new disclosure requirements. Many other regulatory standards are also based on these pillars, requiring not only disclosures to markets, but also to regulators to ensure operations are transparent to supervisory personnel. Transparency is also supposed to be enhanced for supervisory purposes due to extensive reporting requirements applicable to the publicly-traded parent corporations of most large financial-services firms.

However, transparency as a foundational requirement of effective regulation is in doubt due to the following operational impediments:

- complexity, which results from the extremely detailed and often varying requirements applicable to public disclosures by complex financial-services firms under the Basel III standards, the G-SIB requirements and a host of pending Dodd-Frank requirements;

- inconsistency, which results not only from the differing requirements in overlapping disclosure standards, but also from the divergence in accounting standards and credit-risk criteria noted above; and

- uncertain confidentiality, which impedes the ability of regulated institutions to share information with regulators, especially across national borders when host-country protection for proprietary data may not be robust.

Governance of Financial Conglomerates

Banking, securities, insurance and other financial operations often take place in firms that conduct one or more of these businesses within a group structure invariably called a “financial conglomerate,” “financial holding company” or “banking organization” which are subject to an array of rules and regulatory frameworks. In the run-up to the crisis, individual business lines and/or activities in specific jurisdictions were often conducted in “silo” fashion without a clear understanding within the firm of enterprise-wide risk or emerging problems in a major business line. Regulators were similarly unable to judge the total risk profile of a conglomerate or holding company, especially when various activities fell under supervisors not required or allowed to report data to the parent-company regulator or when key operations were wholly unregulated. A key reform following the crisis is thus the effort now under way to address intra-group risk within complex firms engaged in an array of financial-services operations, especially when these operations cross national borders. Major efforts in this area include new standards in the Dodd-Frank Act that give the Federal Reserve Board more authority over subsidiary activities in a financial holding company and top-tier regulatory power over any nonbank financial company deemed systemic. The Joint Forum of global banking, securities and insurance regulators has also issued new standards aimed at improving financial conglomerate regulation.

Absent a robust framework, effective financial regulation and supervision faces a serious operational impediment. However, numerous obstacles to a robust conglomerate framework must be resolved before standards are finalized, including:

- the degree to which rules are “bank-centric” and, thus, fail to recognize the significant differences in nonbank operations and risk;

- blurred distinctions between the Joint Forum standards for financial conglomerates and an array of FSB rules largely implemented on a sectoral basis and/or aimed at regulating “shadow” entities, creating uncertainty as to which standards would govern which firms at the parent-company level and which regulators are responsible for enforcing these requirements;

- uncertain confidentiality of information related to entities within a group when this is transferred to a top-tier regulator in another jurisdiction or with a different legal regime in the same nation (e.g., transfer of information on insurance activities between federal and state regulators in the U.S.);

- governance variations which result from differing responsibilities (e.g., to shareholders, depositors, investors, etc.) mandated for varying operations within a financial group that hinder top-tier governance to a single set of supervisory or firm-wide objectives;

- wide variation in the ability of firms to support unregulated and/or nonbanking activities from the resources housed in insured depositories or similar entities; and

- uncertain application of group-wide governance to firms too far outside the scope of global regulation or structured within holding companies clearly under the Dodd-Frank Act.