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FINANCIAL SERVICES REGULATIONS

Reforms around Accounting Standards and Financial Supervision

How gaps in accounting standards and financial supervision are being addressed for a more stable global financial system

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Contents

1 Highlights

The financial crisis of 2008-09 exposed numerous weaknesses across the global financial system ranging from lack of proper regulatory supervision to inadequate risk management.

In the wake of the financial crisis, accounting and regulatory bodies are focusing on the role played by fair value accounting practices, lack of transparency in the over-the-counter derivatives market, and the under-regulation of the shadow banking market in the proliferation of the crisis. This in turn has led to certain key legislative developments that are being formulated to address these gaps and that are likely to impact financial services institutions and the professional services market.

Although fair value (mark-to-market) accounting was widely criticized for exacerbating cyclical tendencies (procyclicality) in the financial system, accounting bodies and the Financial Crisis Advisory Group played down any need for wholesale changes in this accounting practice. The Financial Stability Board (FSB) however, has suggested certain broad changes in recognition of loan-loss provisions, along with reduced complexity around valuing complex financial instruments. They also support the global accounting convergence project for improved accounting standards going forward.

The phenomenal growth in the global over-the-counter derivatives market over the past decade, which had a notional outstanding value of US$601 trillion in December 2010[1], is also under the Financial Stability Board's scanner due to the contagion risk that it exposes to the market because of lack of transparency. Regulatory reforms in this market are aimed at greater transparency, standardization, and centralized clearing of the derivative contracts.

The shadow banking system, which almost outgrew the traditional banking system during the start of the financial crisis with a total asset base of around US$10 trillion, is also being brought under the regulatory scanner due to its growing importance and the inherent risk it poses to the global financial system.

Overall, these reforms are expected to change the operating fundamentals of the financial system and make it more transparent, tightly regulated, and easily comparable on a global scale.

These regulatory reforms provide opportunities for professional services providers to help financial services institutions modify their IT systems to enable accounting convergence, build a robust compliance system to comply with new regulations, and process real time data for greater transparency in the over-the-counter market.

[1] As per Bank of International Settlements (BIS)

2 Introduction

The financial crisis exposed weaknesses in the global financial system. Chief among them was the web of interconnections across global financial institutions and investments, which resulted in a cascading effect that gained strength and toxicity. Key weaknesses revealed by the financial crisis include:

- Lack of transparency
- Noncompliance of accounting practices
- Inadequate risk measurement and management process
- Misaligned compensation and incentive policies
- Lack of sufficient governance and supervision

Throughout 2008 and 2009, regulators around the world acted quickly to take measures to increase the strength of the overall financial system. Though these regulatory reforms are still evolving, regulators have attempted to fill the gaps that emerged during the crisis (especially regarding risk assessment and measurement), strengthen the capital base, adopt global standards for minimum liquidity, and enhance accounting standards to reduce systemic risks.

As regulations are expected to evolve to create a risk-aware financial system, the momentum for change is converging around six key regulatory themes.

Exhibit 1: Key Themes Driving Regulatory Reforms and Structural Changes across Global Financial Services Institutions

Key Regulatory Themes

Capital

Low levels of capital held by institutions, coupled with high levels of leverage served to multiply risk, were identified as some of the root causes of the financial crisis

Global Cross-Border Regulation

Large, cross border institutions pose special risks hence will be subject to increased scrutiny

Regulatory arbitrage due to non-uniform regulations is a risk to global financial systems stability

Liquidity Management

Financial-crisis highlighted inadequate liquidity buffers and poor liquidity risk management within banks, resulting in a liquidity crisis

Accounting Standards and Financial Regulations

Accounting standards prior to the financial crisis did not reflect the true financial position of financial services institutions hence there is a continued push for a harmonized set of accounting standards

Investor and Consumer Protection

Investors have suffered significant losses during financial crisis that was stimulated in large part due to flawed practices and structural weaknesses of the financial institutions

Remuneration, Governance and Supervision

The focus and link to risk should be improved, and supervisory structures are seen evolving to better detect both idiosyncratic and systemic risks

Source: Capgemini analysis, 2011

This paper focuses on the regulatory reforms emerging around Accounting Standards and Financial Supervision.

3 Current and Evolving Reforms around Accounting Standards and Financial Supervision

The biggest argument against fair value accounting is that it requires making significant judgments and estimates during illiquid markets, which makes these assessments subjective and unreliable.

3.1. Systemic Accounting and Financial Regulatory Weaknesses That Acted as Catalysts to the Global Financial Crisis

What started as a subprime crisis in the U.S. morphed into a global financial crisis, largely due to certain systemic weaknesses in accounting rules and financial regulatory supervision:

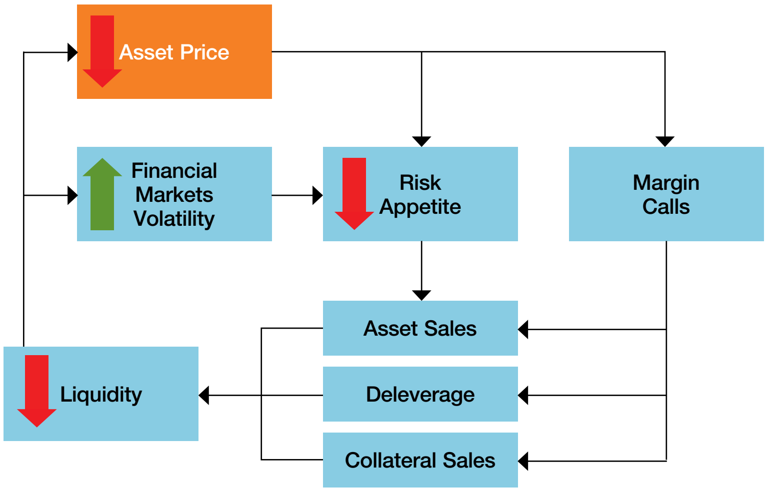
- Prevalence of Fair Value Accounting (FVA) which exacerbated the financial system's procyclicality[2]
- Weak over-the-counter derivatives market structure, which lacks transparency
- Lack of proper regulatory supervision in the shadow banking system[3]

Fair Value Accounting & Procyclicality

The financial crisis highlighted how the current global financial system exacerbates the economic cycle. Though there are numerous reasons for the procyclical nature of the financial system, fair value accounting has been increasingly debated as one of the driving factors for this phenomenon.

Fair value accounting (mark-to-market rule) requires financial services institutions to write down the value of their financial assets to well below their intrinsic value during downturns. As a result, the mark-to-market accounting convention requires financial services institutions to further beef up their capital in order to offset the fall in their asset values. This in effect makes them vulnerable, especially in illiquid markets as was seen during the recent credit crisis. The fair value principle is widely believed to be contributing to the financial systems' instability as it tends to create asset bubbles during economic booms and magnifies the effects of their collapse during the downturn.

Exhibit 2: Impact of Asset Prices on the Banks



Note: Falling asset prices in an illiquid market leads to a vicious cycle in an economic downturn.
Source: Asian Development Bank Institute

[2] Procyclicality can be defined as the state of positive correlation between an industry and the economic cycle
[3] The shadow banking system can be defined as any kind of credit intermediation involving entities and activities outside the regular banking system

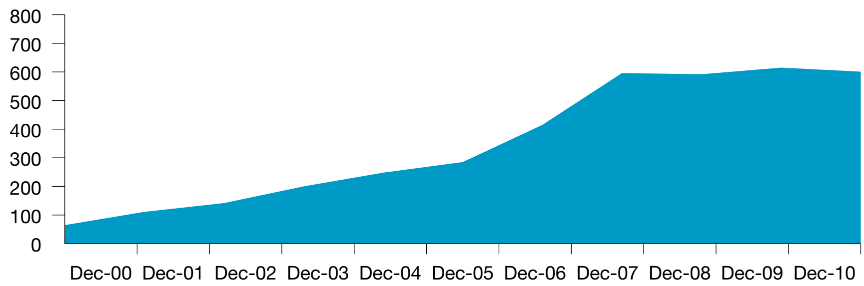
Weak Over-The-Counter Derivatives Market Structure

Over-the-counter derivatives have largely helped the financial markets as well as large corporates in their risk mitigation process, especially over the past decade.

The credit crisis highlighted the potential for a contagion risk arising from the interconnectedness of the market participants and the lack of transparency in certain counterparty relationships. The role of over-the-counter derivatives in the financial market collapse cannot be underestimated as they were central to the Lehman Brothers bankruptcy as well as American International Group's near collapse before being bailed out by the U.S. government. In short, the global over-the-counter derivatives market has grown exponentially over the past decade and is estimated to have a notional value of US$601 trillion based on outstanding contracts as of December 2010. This huge market can pose immense risk to the global financial system in its current state due to under-regulation and lack of proper transparency.

Under-Regulation in the Shadow Banking System

Exhibit 3: Growth in the Over-The-Counter Derivatives Market by Notional Value (US$ Trillion)



Source: BIS, 2011

The estimated total assets of the so-called shadow banks (which includes hedge funds, conduits, government sponsored entities, structured investment vehicles, money market funds, investment banks, and other non-banking financial companies) was approximately US$10 trillion at the beginning of the financial crisis in late 2007, almost on par with the traditional depositary banking system.

These shadow banks have been playing an increasingly important role in credit channelization and liquidity transformation in the modern financial world. Despite the ever-growing role of shadow banks in the financial system, and their systemic importance, they were not subjected to the same stringent regulations as banks. It was due to this light-handed regulatory approach that some of the investment banks such as Lehman Brothers and Bear Stearns were able to operate with extremely high leverage. Moreover, these financial services institutions purchased illiquid assets such as mortgage-backed securities by borrowing on a short-term basis, which made them over-reliant on the availability of short-term lending. The result was not just their failure, but a worsening of overall credit availability in the market.

3.2. Legislative Reforms and Other Development Activities at the Global and Regional Level

In an effort to restore and further strengthen the stability of the global financial industry, global leaders from the G20 nations have set up the Financial Stability Board (FSB) which in turn has come out with a broad set of recommendations[4].

[4] Improving Financial Regulation (Report of the Financial Stability Board to G20 Leaders, September 2009)

The Securities and Exchange Commission (SEC) is scheduled to decide by 2011 year-end whether U.S. companies should switch over to using international rules altogether.

"Anything that does what a bank does, anything that has to be rescued in the crises the way banks are, should be regulated like a bank"

Paul Krugman, Economist

Fair Value Accounting & the Accounting Convergence Project to Mitigate Procyclicality

- Accelerate the project of global accounting convergence towards IFRS[5] and its attainment by 2011 to bring out a single set of uniformly applicable global accounting standards.
- Reduce the complexity of accounting standards for the valuation of financial instruments and thus address the valuation uncertainty in fair market valuation guidance and regulatory arbitrage.
- Enhance the provisioning for all off balance sheet exposures for valuation purposes.
- Strengthen the accounting recognition of the provisions for loan-loss by incorporating a wider range of credit information in order to improve transparency.
- Make a case for accumulating additional capital buffers during economic upcycles, which allows them to draw them down during the downturns.

Streamline the Over-The-Counter Derivatives Market and Improve Its Transparency

- When suitable, all standardized over-the-counter derivative contracts need to be traded on exchanges or electronic trading platforms, and cleared through central counterparties by the end of the 2012 calendar year.
- Mandatory reporting of over-the-counter derivative contracts with the trade repositories.
- Discouraging non-centrally cleared contracts by subjecting them to higher capital requirements.
- A closer look at the regional- and national-level efforts to improve the over-the-counter derivatives market structure reveals that the U.S. has been in the forefront in overhauling over-the-counter markets through the introduction of the Dodd-Frank Act, which requires all centrally and non-centrally cleared contracts to be reported to a data repository or the Securities and Exchange Commission. On the other hand, the European commission has made some recommendations such as mandatory reporting of over-the-counter derivatives and clearing of eligible over-the-counter derivatives, which is set to change the over-the-counter market structure on a rapid scale.
- While Asia-Pacific has not felt the need for big ticket regulatory reforms, the member countries of the Financial Stability Board have made some reasonable progress. For instance, Japan has amended the Financial Instrument and Exchange Act, while Korea and Hong Kong have set up a task force to examine issues in clearing and reporting of over-the-counter derivatives. Additionally, China has set up the Shanghai clearing house.

Prudential Regulation of the Shadow Banking System

- Emphasis on increased supervision of the shadow banking system.
- Enhanced monitoring through data collection processes which would enable the Financial Stability Board to assess global financial trends and risks from 2012 onwards.
- Additional regulatory action on an as-needed basis in identified areas, which include banks' interactions with shadow banking entities, money market funds, and securities lending and repos.
- Multiple legislative efforts directed towards regulating the shadow banking system. The rules for investing in money market funds have been modified in the U.S., the process of securitization has been reviewed in Europe and the U.S., and the Dodd-Frank law has empowered regulators to freeze hedge fund operations in case of emergencies.
- A call for increasing the purview of financial regulation. The International Monetary Fund has highlighted all financial institutions, instruments, and markets that are currently unregulated, along with the need to widen the regulatory net on other systemically important financial services industries which were earlier under-regulated.

[5] IFRS stands for International Financial Reporting Standards adopted by the International Accounting Standards Board

4 Business Implications for Financial Services Institutions

4.1. The Impact of Regulatory Reforms on Financial Services Institutions

Various new legislative reforms and developments aimed at improving the stability of the global financial services industry are expected to significantly impact the operational environment for financial services institutions. However, these changes are gradually expected to create a financial world with a more transparent over-the-counter derivative market, tightly regulated shadow banking system, coupled with globally comparable accounting standards.

Key Implications of Accounting Reforms around Fair Value Accounting & Convergence to Financial Services Institutions

- Mandatory additional disclosures and increased amount of independent assessment is expected to significantly increase the cost of reporting.
- Despite higher one-time IFRS conversion-related costs, the new converged accounting standards are expected to improve transparency, consistency, and comparability. This will in turn reduce the cost of the funding for financial services institutions in the longer term.
- For investment management firms, the global accounting convergence towards IFRS is expected to reap indirect benefits in the form of easier comparability of firms on a global scale and better procedures to value complex financial products.
- Moreover, to promote better valuation practices financial services institutions are expected to follow certain best practices, such as forward-looking provisioning for loans at the time of loan initiation. Proactive provisioning coupled with strong capital buffers is expected to mitigate the procyclicality of the financial markets to a large extent.

Key Implications of Over-The-Counter Derivatives Market Reforms to Financial Services Institutions

- Financial services institutions need to have an increased access to clearing houses by becoming members of the relevant clearing houses or by outsourcing it to third party clearing brokers in order to continue entering into clearing eligible derivative contracts.
- Financial services institutions face reduced liquidity and increased transaction costs for the derivative contracts on account of the greater margin requirements of cleared over-the-counter derivative trades vs. non-cleared ones.
- Increased reporting requirements might require significant upgrades to existing operating systems.
- Financial services institutions have a major role to play in consultation with national regulators to decide the feasibility of certain Financial Stability Board recommended over-the-counter derivatives market reforms for different classes of over-the-counter derivatives at a national level.

Key Implications of Shadow Banking Reforms to Financial Services Institutions

- A larger number of shadow banking activities and entities would now fall under the regulatory sphere due to the macroprudential regulatory approach as opposed to the microprudential approach followed earlier.
- Increased regulatory focus on debt maturity, especially after the collapse of large financial services institutions such as Lehman Brothers, Bear Sterns, and Northern Rock is expected to bring down overdependence on short-term funding.
- Stricter regulations, which are more or less in line with the banking industry, are expected to reduce the incentive for lending activity to migrate to the shadow banking industry.

The recent closing of Quantum Fund to external investors by George Soros is probably one of the casualties of the new shadow banking regulations in the U.S. The new regulations around shadow banking require private investment advisors to register themselves with the SEC by March 2012. More such actions from the shadow banking institutes cannot be ruled out due to the new regulations.

5 The Path Forward: Imperatives for Financial Services Institutions

With reforms such as the accounting convergence towards IFRS gaining steam across the world, and various national-level legislations being passed in order to better regulate the shadow banking industry, most financial services institutions are feeling the need for upgrading or modifying their existing systems and infrastructure to comply with the changing requirements:

- **Modified IT systems to enable accounting convergence:** Financial services institutions that were earlier following the U.S. GAAP or other national accounting standards are expected to effectively plan for and make some capital investments in their IT systems. The new IT systems should help them address issues related to reporting, certain calculations, and other new data requirements to comply with the new internationally followed IFRS standards.
- **Need for robust compliance system to abide by certain new regulations:** Most financial services institutions, especially the shadow banks, are now subjected to stringent regulations as a part of their basic operations due to the macroprudential regulatory approach. These new regulations would require them to build their existing IT infrastructure especially for compliance management in areas such as electronic record management, financial reporting, and data security.

Moreover, major regulatory reforms are being implemented in the global over-the-counter derivative markets aimed at increasing transparency in the market. Various financial services institutions, which have significant presence in the over-the-counter derivatives market, can be better prepared to comply with these reforms by making certain adjustments to their existing system infrastructure. Some of their IT requirements include increased process automation by replacing certain manual processes to provide real time data and better document management for maintaining records and monitoring compliance.

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- Investor and Consumer Protection
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