Private Sector Taskforce

of Regulated Professions and Industries

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The Group of Twenty
C/- His Excellency José Antonio Meade
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PRIVATE SECTOR TASKFORCE OF REGULATED PROFESSIONS AND INDUSTRIES RECOMMENDATIONS TO THE G-20 UPDATE OF 2011 REPORT; IMPLICATIONS FOR 2012 AND BEYOND

Dear Secretary Meade:

The Private Sector Taskforce of Regulated Professions and Industries (PSTF) is pleased to provide an update of matters outlined in its 2011 Report on Regulatory Convergence in Financial Professions and Industries (”2011 Report”), issued to the G-20 Deputies in September 2011. A copy of the 2011 Report is attached to this letter.

First, the PSTF strongly encourages the G-20 to implement all of the 15 recommendations presented in its 2011 Report. Further, in support of these recommendations, this letter provides a discussion of relevant matters that have arisen since the report was issued. This includes examples of where regulatory convergence has moved in a satisfactory direction, as well as examples of situations where the opposite has occurred; in particular, drawing attention to areas where international regulatory arrangements have become more fragmented.

Additional recommendations are included with respect to public sector financial management, which over the last year has been brought into greater focus as a consequence of the sovereign debt crisis that has contributed to instability in the global financial system and remains a significant threat. Finally, other important matters are identified, which the taskforce suggests will require closer attention by the G-20 in 2013 and beyond.

Background of the PSTF

The PSTF was established in May 2011 at the request of the then Presidency of the G-20. Its principal aim was to provide an analysis of, and recommendations relating to, regulatory convergence to facilitate economic stability in the world's capital markets.

Establishment of the PSTF was coordinated by the International Federation of Accountants (IFAC), which has provided administrative and secretariat support for the taskforce. The PSTF is comprised of representatives from international private sector organizations of professions and industries that are subject to regulation and operate within the financial sector. In addition to IFAC, the membership of the taskforce is comprised of: the CFA Institute (CFA I); INSOL International; the Institute of International Finance (IIF); the International Accounting Standards Board (IASB); the International Actuarial Association (IAA); the International Corporate Governance Network (ICGN); the International Insurance Society (IIS); and the International Valuation Standards Council (IVSC).

Why Regulatory Convergence is Important

As described in the 2011 Report, a major motivating factor for enhanced regulatory coordination, cooperation, and convergence is to minimize the effects of systemic risk that result from inconsistent or inappropriate regulatory arrangements for globally important and increasingly interconnected industries, such as the financial sector. Effective, robust, appropriate, and consistent global regulation facilitates the early detection and timely mitigation of potentially serious systemic risks that can readily be transmitted, with effects across borders being capable of creating a global crisis such as that witnessed in recent years.

In addition, regulatory convergence can reduce the economic costs and inefficiencies that result from regulatory differences between jurisdictions that in turn facilitate regulatory arbitrage. A more stable and consistent base of regulation creates an atmosphere of greater certainty for business and minimizes the potential for a regulatory "race to the bottom," unfair competition, and cross-border contagion risks. Further, the PSTF recognizes that achieving regulatory convergence should not be viewed as necessarily imposing greater regulatory requirements (which in some cases, adds burdens and cost without corresponding benefits) on those parties subject to regulation. At the same time, it is not synonymous with simple acceptance of the lowest common denominator of regulatory oversight.

Greater financial and economic stability can be facilitated through appropriate regulatory reforms and practices that are both effective and efficient in achieving their objectives. Although current regulatory reform efforts are being considered in reaction to the global financial crisis, it is important that governments and regulators adhere to the principles of high-quality regulation, developed through economic impact assessment, considering both short- and long-term effects, as far as is practical.

Furthermore, the global regulatory community should endeavor to promote mutual recognition of regulatory arrangements by other jurisdictions, where they are consistent with, or based on, internationally recognized, high-quality standards and principles. This will help regulators and supervisors cope with the potentially greater complexity and intensity of regulations in the post-crisis environment, while at the same time achieve essential efficiencies for companies operating in the financial sector; both of which are necessary for a smoothly operating international capital market.

Proposals for regulatory reforms should be informed by, and based on, sound empirical evidence and should consider the differential impacts and effects across different types of economies, including the emerging economies that can provide a significant contribution to global economic growth. Most of the analysis that has been undertaken has a local or regional focus and is, perhaps not surprisingly, less focused on the global impact. For example, some elements of the regulatory reforms affecting the auditing profession recently proposed by the European Commission such as mandatory audit firm rotation and prohibitions on the provision of non-audit services, have been criticized for the lack of strong empirical evidence obtainable through an impact analysis and an insufficient consideration of potential extra-territorial effects. . In other areas (for example, the requirement for the adoption of International Standards of Auditing) a more thorough analysis has been undertaken and is reflected in the strong support received in the consultative process.

With respect to the proposed European regulation and directive on statutory audits, an assessment of the impacts on the costs and governance of European companies, including the role and operation of audit committees, and the potential disenfranchisement of shareholders and investors, warrant further consideration. Ideally, such assessments should consider the impact of proposed reforms both in the region and outside it, the impacts that similar regulation has had in other jurisdictions, and the effects of the removal of the regulation they will replace (which, in the example given, was fairly recently implemented and have not been properly assessed in terms of whether it has achieved its aims).

Recommendations and Updates

While all 15 recommendations included in its 2011 Report remain valid and crucial to the achievement of the agenda of the G-20, the PSTF strongly reinforces its first two recommendations, encouraging the G-20 to:

- Continue to focus on regulatory convergence in the financial sector, ensuring that G-20 nations work together to identify and narrow gaps in regulatory practice; and

- Discourage nations from implementing unilateral national regulatory reforms that are inconsistent with international standards and that widen—rather than narrow—the convergence gap.

It is becoming increasingly apparent that striving to achieve these two principles will be especially important in the complex regulatory environment now being created.

Recent media speculation suggests that the momentum of the G-20 may have slowed, and that some member countries are permitting national, and regional, interests and concerns to over-ride the global imperative. Regulatory fragmentation, heightened potential for regulatory arbitrage, and adverse extra-territorial impact of disparate national and regional legislation that fails to consider its impact outside of that nation or region, may derail the advancement of the global agenda and increase the risk that future global financial crises will result. It is critical that the G-20 nations continue to coordinate their efforts in addressing the global problems such as those that emerged during the global financial crisis, as well as the ensuing sovereign debt problems.

While recognizing that moving forward a global regulatory reform agenda is a daunting task, the PSTF notes that there have been noticeable differences in the pace and structure of change in particular elements of the agenda. Some have argued that an almost overwhelming number of reforms have been proposed and promulgated with respect to the regulation of financial institutions, while reforms pertaining to investor and consumer protection are moving at a somewhat slower pace. While it is unreasonable to expect that reforms will be enacted in a uniform manner across all parts of the international financial sector, it is important for the G-20 to recognize both the inter-connectedness of the sector and how a failure to consider and address issues in one area may impact the effectiveness of reforms in another.

The following examples demonstrate situations in which progress has been made towards global regulatory convergence in some parts of the broader reform agenda, and how, in contrast, decisions made in some jurisdictions have been detrimental to advancing this agenda.

Examples of areas where progress towards global regulatory convergence has been advanced:

- Legal Entity Identifiers (LEI) – work undertaken to develop LEIs is an excellent example of a constructive collaboration between the private and public sectors, in which significant progress has been made toward data standardization in the financial sector. Assuming G-20 endorsement at its meeting in June, LEI as a global standard will constitute a significant step forward, both for the macroprudential understanding of global markets by regulators and for internal risk management, including the important Financial Stability Board (FSB) mandate of recognizing exposure aggregation by firm. While the pace of development of LEI has been unprecedented in the realm of global standards, much remains to be done and public sector support will be required. Once the LEI process is stabilized and there is increasing global usage, the FSB and its collaborators will be able to consider proceeding with further developments such as Product Identifiers and the syntax rules that can lead to a true "global language" of exposures and risks. Such initiatives have the potential to deliver great efficiency gains for the economy, as well as enhanced macro prudential oversight.

- Adoption of International Financial Reporting Standards (IFRS), identified by the FSB as key for sound financial systems and deserving of timely implementation, by a growing number of countries – in the last year an additional five jurisdictions have adopted, or have signaled their intention to adopt, IFRS. This brings to around 120 the total number of jurisdictions that use, or intend to use, IFRS. In addition, over 70 jurisdictions have adopted the "IFRS for SMEs" standards or have proposed publically a plan to do so. Globally accepted, high-quality international standards and requirements that are developed, adopted, implemented, and interpreted consistently are essential to assess concerns regarding organizations operating across borders, where the operations of organizations within one jurisdiction affect those in other jurisdictions, can reduce the inefficiencies and costs that result from duplicated or inconsistent regulatory requirements and the potential for regulatory arbitrage. However, despite these positive signs, uncertainties with respect to financial reporting convergence still exist. For example, the situation remains unsatisfactory on one very important topic for financial institutions—netting and set-off—where convergence has not been possible. The current solution to this lack of convergence appears to be the use of two inconsistent standards (IFRS and US Generally Accepted Accounting Principles), inefficiently and imperfectly reconciled by additional disclosure standards.

- Adoption of International Standards on Auditing (ISAs) in Europe – in its proposed legislation on auditing issued last November, the European Commission signaled its intention to adopt "Clarified ISAs"[1] for audits of public interest entities. Adoption in Europe would bring to 85 the number of

[1] "Clarified ISAs" are the latest set of standards issued by the International Auditing and Assurance Standards Board. They were issued in 2009. The number of jurisdictions that have adopted, or signaled their intention to adopt, ISAs more generally (including either the former set of ISAs or "Clarified ISAs") totals over 120.

jurisdictions around the globe that have adopted, or have signaled their intention to adopt, ISAs. The importance of global adoption and implementation of ISAs is similar to that of IFRS. ISAs are also a set of standards identified by the FSB as key for sound financial systems and deserving of timely implementation.

Examples of areas where progress towards global regulatory convergence has slowed, and where regulatory fragmentation and extra-territorial impacts of national and regional legislation actions are evident:

- Dodd-Frank and the “Volcker Rule” – these proposed US rules pertaining to prohibitions and restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds (the “Volcker Rule”) may have significant extra-territorial effects that impact non-US banks, international issuers, and international markets. Furthermore, it places extra-territorial burdens on US firms operating in global markets, as well as adversely affecting non-US government bond markets.

- Foreign Account Tax Compliance Act (FATCA) – enacted in the US in 2010 to deter tax evasion, FATCA represents a unilateral approach taken by one jurisdiction, which has extra-territorial consequences that create significant risks and costs for international financial systems, and poses a potential threat to financial stability. The reporting, compliance, and withholding requirements contained within the Act have the potential to dramatically affect payment flows, investors, and financial institutions that have little connection with the US, and in some jurisdictions may contravene local laws. Recently proposed regulations alleviate only a small part of the problems resulting from raising due diligence thresholds. The proposed joint agreements with some countries will alleviate one of the major issues—conflict with data privacy laws—but only in those countries involved. A solution to these problems created by FATCA might be to suspend its application in these areas and to concentrate on the completion of international standards on tax reporting and payments as contemplated in the joint statement between the US and the other “FATCA partner” countries.

- European data protection laws – the laws have highly problematic extra-territorial effects, and proposed changes that require companies to provide details of breaches to authorities will have disruptive and protectionist effects. Such reporting will need to be done within 24 hours of the occurrence of the breach, and companies can be fined up to two percent of their global annual turnover if they breach proposed EU data laws. This will have protectionist effects by, in effect, requiring the processing of data to be performed within the EU, thereby placing substantial barriers in the way of FSB efforts to develop comprehensive macroprudential data on markets. Consequently, it will make it more difficult to sell foreign financial products in the EU. While protection of individual data privacy is an important concern, the aggressive, unilateral approach being taken to this matter will potentially fragment broader markets in ways that will ultimately be detrimental to consumers.

- Revised guidelines for the valuation of collective investment schemes – the revised guidelines, which were the subject of a recent consultation by the International Organization of Securities Commissions (IOSCO), appear to have failed to reflect the importance of reducing the diversity of valuation practice in different parts of the world. The consultation provided an opportunity to recognize the importance of global regulatory convergence, and to promote the position that valuations on which investors and others rely should be provided in a consistent professional manner with due regard to practice, competency, and ethical behaviour.

Additional Recommendation: *Public sector financial reporting, transparency, and accountability*

In its 2011 Report the PSTF indicated that public sector reporting, transparency, and accountability are of significant concern to the private sector. It noted that the sovereign debt crisis engulfing several countries is a major concern for the G-20 and other countries. Deficiencies in fiscal management in the public sector appear widespread, and have caused significant economic harm. Policies chosen to address the global financial crisis may inadvertently have changed the nature of—and amplified—the problem, by moving the financial crisis from the corporate to the government sector.

It is important that institutions for fiscal management are structured to provide the necessary constraints and incentives for governments to manage their finances in a manner that protects the public interest as well as investors in government debt. Furthermore, it is important that public sector financial reporting is undertaken using high-quality, globally recognized accounting standards (e.g., International Public Sector Accounting Standards (IPSASs)).

The PSTF recommends that the G-20:

- ***Facilitate urgent and fundamental work, to be conducted or commissioned by the FSB, to consider the nature of institutional changes needed in public sector financial management to protect the public and investors in government bonds.***

- ***Encourage the FSB to include IPSAS as one of the set of standards recognized as key for sound financial systems and deserving of timely implementation.***

The PSTF encourages the G-20 to initiate such work through the FSB, which should look at examples of institutional arrangements for public finances in jurisdictions in which fiscal positions have been well managed, and recognize that the issues that need to be addressed are ones in which governments themselves are self-interested parties. Arrangements that might be considered include:

- High-quality and timely accrual-based financial reporting, with audited financial statements released within less than six months of year end;

- Budgeting, appropriations, and reporting on the same accrual basis;

- Full transparency in fiscal positions, especially ahead of general elections, ensuring that voters are fully informed; and

- Limitations on deficit spending, or at least full transparency regarding the reasons for deficit spending and explanation of how, over at least the next economic cycle, fiscal balance will be restored.

Other Matters of Focus for 2013 and Beyond

There are several matters that the PSTF has identified as being of significance to the G-20 in attaining global regulatory convergence, and promoting greater financial and economic stability and growth. They are matters upon which greater attention should be focused by the G-20, and G-20 nations, in upcoming years. The PSTF will provide more detailed discussion of them—and further recommendations—in its subsequent reporting to the G-20. These matters include:

- Shadow banking – The FSB has recognized the likelihood that increasing regulation of the mainstream financial services industry, including banks and insurance companies, creates a risk that part of the credit generation in the global system may migrate to less-regulated financial processes, which are imprecisely known as “shadow banking”. [2] Balance needs to be struck between unregulated risks that could grow to systemic proportions requiring further regulation, and avoidance of disproportionate reactions that could impede the growth of beneficial, alternative means of finance, necessary to ensure adequate credit provision. To avoid systemic risk, and the creation of unfair competitive situations for the prudentially regulated sector, it is important that the macroprudential monitoring process envisioned by the FSB include active, robust, and continuous monitoring for new types of activities or combinations of transactions that may fall within the breadth of “shadow banking” (i.e., potential risks of maturity transformation, liquidity transformation, credit-risk transfer, and leverage). Such monitoring should be sensitive to market and economic benefits as well as risks, with regulatory responses being proportionate to actual risks. Responses should not impose prudential regulatory requirements where existing conduct-of-business requirements are sufficient (as in many

[2] Refer: FSB, *Shadow Banking: Strengthening Oversight and Regulation,* October, 2011.

securities and securitization transactions). Decisions to impose further regulation should take into account the effects of other regulatory changes.

- Credit rating agencies – Recommendation 14 of the 2011 Report encourages the G-20 and the FSB to achieve internationally workable and consistent standards for and supervision of credit rating agencies. While proposals for enhanced regulation have been put forward by the EU and the US, there has been little international coordination and cooperation on these matters. This fragmented approach does not augur well for achieving the goal of avoiding undue reliance on external ratings, especially by prudential regulators, financial institutions, and credit providers. Considerable uncertainty has been created in this area, as in other areas, by standards calling for recognition of "equivalent" foreign regulation. While this is laudable and appropriate if carried out in an appropriate and consistent manner, and with due recognition of the parallel intent of foreign regulation, it can also result in generating—rather than reducing—problems of extra-territoriality and protectionism. A more coordinated global effort needs to be undertaken on this topic.

- Social insurance and long-term sustainability – Recent attention of the G-20 has understandably been focused on the immediate issue of global financial stability. Nevertheless it is important that transparent quantification of the future cost of social insurance programs, prepared in an objective manner, be provided to public policy decision makers and the public generally, to enable timely actions to be taken, where appropriate. Given the profound demographic changes occurring globally, the long-term sustainability of social insurance programs needs to be ensured, as citizens of the G-20 countries will in many cases rely on these programs. In addition, continued low interest rates may adversely affect the cost of, and ability to provide, these and other retirement benefits.

- Disaster risk management – The PSTF agrees with the February 2012 Communiqué from the meeting of Finance Ministers and Central Bank Governors that effective disaster risk management is both a desirable local and global need. Given its significant effect on individuals and companies, this is an area in which private-public sector cooperation is needed. Natural and man-made disasters can have a significant negative impact on economies at the local, regional, and the global levels. In particular, the insurance business and the actuarial profession can provide assistance to better manage potential adverse financial effects.

Please do not hesitate to contact the taskforce if you have any questions, or require further clarification, regarding the matters included in this letter, or in the attached 2011 Report. Inquiries and questions may be directed to the taskforce, care of Mr. Russell Guthrie, Executive Director, IFAC at +1-212-471-8708, or russellguthrie@ifac.org.

Representatives from the taskforce would be pleased to meet with representatives from the G-20 to discuss regulatory convergence in financial professions and industries, and to identify ways in which the taskforce may be of assistance to the G-20 in 2012 and beyond.

Yours sincerely,

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For and on behalf of the Private Sector Taskforce of Regulated Professions and Industries:

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