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Editorial: The FSB, BCBS and SIFIs and why partnership is required

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After the financial crisis of 2007-2008 one new standards body, the G20's Financial Stability Board (FSB) and one old standards body, the Basel Committee on Banking Supervision (BCBS) was tasked with stabilizing the global economy. They have since set an agenda for those they saw as the most significant participants in destabilizing the global economy, systemically important financial institutions (SIFIs). It's now time that these global financial institutions organize themselves as a group to begin the dialogue with these two global standards setters. Setting the architecture for a risk adjusted financial system and, in turn, setting each SIFI on the long journey to reengineer their own institutions should be a shared responsibility. A well-established partner of SIFIs, their auditors, should be invited to the table.

The lessons of the financial crisis taught us that global financial institutions are unrestrained by sovereign boundaries of regulation. It also revealed that regulators are critically dependent on accurate, timely and aggregatable data to observe risk building up in the financial system. Regulators were unable to see into the financial institutions that they were mandated to oversee.

Another, more fundamental observation is that the discipline of risk management had for too long been burdened by neglected technology improvements. The global financial industry's technical ecosystem looks more like a Rube Goldberg or Heath Robinson contraption, those ridiculously complicated machine depictions designed to accomplish a simple objective, than anything well thought through around good systems design.

Finally, evidence from the financial crisis supported known accounting deficiencies that life-threatening exposures to risk were accumulating in financial institutions defying identification and quantification and, consequently, were not reported in audited financial statements. This represents both a risk quantification challenge and an accounting challenge. They are inextricably linked.

Since that time regulators have put the global financial system under pressure to conform to a new regulatory order and to the new technologies of the information age. It is well understood that technology would be the enabler of these regulations. Regulatory change would finally be understood through the lens of the challenges to change enterprise risk, data and technology ecosystems that support these vast and complex global financial organizations, now relabeled as systemically important financial institutions (SIFIs).

To date SIFI designations have been applied to thirty global systemically important banks (G-SIBs) and nine global systemically important insurance companies (G-SIIs). The task of implementing the new risk regime is being tested in SIFIs, where these two standards setter's frameworks will also meet its ultimate test, and where 'the rubber will hit the technology road'.

Toward this end the FSB and the BCBS have developed new frameworks to assist the downstream regulators in observing implementations and in offering remedies of deficiencies detected in the infrastructure of these large, global institutions. The BCBS has been busy reinventing the capital adequacy risk regime - presenting leverage ratios, liquidity measures and criticizing their own acceptance of VaR market measures in favor of simpler and more sensitive measures of risk under stress conditions. Stress tests are now being performed on an annual basis throughout most of Europe, the UK and the US and more standardized benchmark measures are being pursued.

The FSB has set out to change the financial system fundamentally, prescribing criteria for improving risk culture and creating long overdue data identification standards (the 'Barcodes of Finance') for all participants and all their products in the global financial supply chain. The BCBS is asking for these codes be used in their mandate for aggregating data for reporting risk and for calculating capital adequacy.

The FSB has invited auditors to play a more prominent role in assisting in its mandates to stabilize the global economy. Auditing firms, as a group, are the most knowledgeable and intimate external partners of financial institutions. They are called upon by governments and courts, by corporations and individuals, and by regulators to be fair minded, objective analyzers of facts and arbitrators of contentious issues.

The FSB's request for auditor involvement has drawn comparisons to the US's Sarbanes Oxley (SOX) legislation and similar legislation that were enacted globally with the aim of reducing the risk of material misstatements in financial reporting. In a similar comparison, the BCBS issued new requirements for the accuracy of banks' risk data by requiring its reconciliation to a bank's accounting data, the latter being the usual domain of auditors.

A series of regulatory initiatives since then have surfaced to involve auditors even more directly in the global regulatory regime.

Germany has taken the lead in formally using independent auditors to assist in the supervision of their new risk mandates associated with the European swaps regulatory regime. The US is suggesting a role for auditors in independence testing of the Volcker rule. The FSB has described a trusted third party to be interposed in their derivatives regulations for anonymizing data where sovereign regulations require it, a natural extension of the auditors' trusted third party assurance role.

The FSB has defined accounting consolidation rules as the way to organize legal entities into their ultimate control hierarchies for determining counterparty risk in the FSB's evolving global identification system. That this system is properly provided with high quality data on ownership and control structures is a natural activity for auditors: it is an extension of auditors' privileged need-to-know role with their SIFI clients; it recognizes their accounting rules knowledge for consolidations for their materiality attestation function; and it can leverage their skills in third party assurance services.

Let's follow German leadership in using auditors in the new swaps regime and the US and other countries in SOX compliance to move the BCBS's and FSB's framework initiatives forward by extending accountants and auditors roles in risk oversight. Further to involve the SIFIs and their Big 4 auditors in an organized group to interface with the FSB and the BCBS on matters of risk, data and technology.

SIFIs in such an interactive working group should be more inclined to define and embrace shared solutions. The FSB and BCBS, in turn, should be inclined to provide incentives of more implementation time and capital offsets for implementing such shared solutions, ones which make observing risk in these global organizations more transparent, timelier and more automated.

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