REGULATORY DIVERGENCE: COSTS, RISKS, IMPACTS

AN INTERNATIONAL FINANCIAL SECTOR STUDY BY BUSINESS AT OECD AND THE INTERNATIONAL FEDERATION OF ACCOUNTANTS

IFAC International Federation of Accountants®

Business at OECD
THE BUSINESS AND INDUSTRY ADVISORY COMMITTEE

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FOREWORD

Building on research by the Organisation for Economic Co-operation and Development (OECD) on regulatory policy, this international, financial-sector study aims to help regulators and policy makers better understand the benefits of effective international regulatory cooperation.

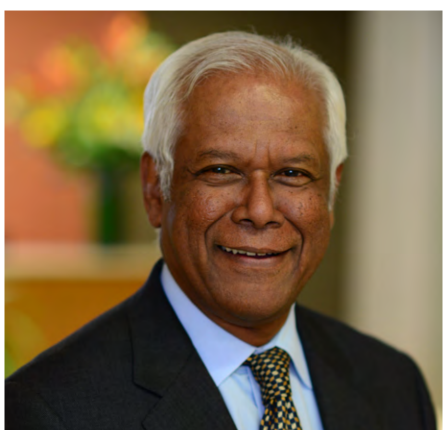
This survey of more than 250 experts and leaders at financial institutions throughout the world's major financial centers highlight the costs and impacts of regulatory divergence and uncover practical, actionable solutions.

The findings show that regulatory divergence costs financial institutions 5-10% of their annual turnover (on average). This consumes scarce senior management time, as well as capital, that could otherwise be focused on identifying emerging risks in the financial system. Ultimately, these costs are a barrier to international growth: more than $780 billion annually in costs to the global economy are conservatively inferred by the findings.

Experts and leaders participating in the study point to practical problem areas, and suggest actionable steps to curb the impacts of financial regulatory divergence, including aligning regulatory definitions, increasing awareness and coordination in regulatory reporting requests, and enhancing transparency in rule making, monitoring, and enforcement processes.

We urge regulators and policy makers to place utmost priority on achieving effective international regulatory cooperation. We also call on the OECD to maintain a leading role in this area. Doing so is crucial to building trust and confidence in effective regulation, thereby fostering a safer global financial system, which ultimately underpins thriving economies.

Bernhard Welschke
Secretary General, BIAC



Fayezul Choudhury
Chief Executive Officer, IFAC

EXECUTIVE SUMMARY

Regulatory divergence in the financial sector is causing material, increasing costs to the global economy, exacerbating risks in the financial system, and impacting economic growth.

Regulatory divergence refers to inconsistencies in regulation between different jurisdictions, which may reasonably arise from cultural differences, domestic policy priorities, or other factors. However, in the financial sector, the need for interconnectedness and the free flow of capital mean these regulatory divergences can often represent more of a burden than a benefit for the economies involved.

This joint International Federation of Accountants (IFAC) and Business at OECD (BIAC) study on the costs and impacts of regulatory divergence was conducted with the participation of compliance and risk management officers as well as senior leaders in financial sector institutions with operations throughout the Americas, Europe, Africa, Asia, Oceania, and the Middle East. Respondents' institutions ranged in size from less than $US 10 million to $1 billion+ annual turnover, including designated global systemically important institutions.

"Every dollar spent on managing incoherent regulatory reporting requests is a dollar that isn't put back into the economy through lending."

– Banking Risk Management Officer, US

KEY FINDINGS

- Regulatory divergence is resulting in material and increasing costs in the financial sector globally, consuming on average between 5-10% of annual turnover.
- Over the past five years, 51% of financial institutions have had to divert resources away from investment in risk management activities as a result of regulatory divergence, including senior management time and capital.
- Regulatory divergence represents a moderate to substantial barrier to most financial institutions' international growth.
- The costs arising from regulatory divergence are more material to smaller institutions.
- Divergence in competition law, market based regulation, and product regulation/consumer protection cause the most material costs.
- Inconsistencies in supervisory interpretations and practices, fundamentally different regulatory frameworks, and different regulatory or data definitions are the most significant inconsistencies.

RECOMMENDATIONS

Achieving more effective regulatory cooperation and harmonization should be a priority for policy makers with the urgency and importance indicated by the associated costs, growth impediments, and potential impacts on financial stability.

Key steps to curb regulatory divergence include:

- Enhanced international regulatory cooperation[1]
- Overall increased alignment in rules
- Improved alignment in regulatory definitions
- Better communication and awareness among regulatory agencies internationally to avoid duplicating reporting requirements and processes
- Greater transparency in rule making, monitoring and enforcement processes
- Greater overall clarity in rules and regulation

[1] International regulatory cooperation (IRC) refers collectively to a variety of approaches, such as negotiated agreements or treaties, regulatory partnerships, supranational institutions, or inter-governmental organizations, regional agreements, mutual recognition agreements, trans-governmental networks, and formal requirements to consider IRC when developing regulations. IRC is an important solution as it has the capacity to foster regulatory coherence while preserving countries' sovereignty, and addressing unique cultural and domestic policy priorities.

REGULATORY DIVERGENCE: COSTS

ON AVERAGE, RESPONDENTS REPORTED THAT 5-10% OF THEIR INSTITUTION'S ANNUAL TURNOVER IS CONSUMED BY COSTS RELATED TO REGULATORY DIVERGENCE.

- 75% of respondents said costs incurred as a result of regulatory divergence are material or very material to their institution's overall financial performance.
- Costs incurred by respondents' institutions dealing with regulatory divergence included:
- Increased head count to manage local, international, and cross-jurisdictional regulatory matters.
- Training costs for personnel to deal with regulation and legislation across different regions, in addition to cross-jurisdictional issues.
- Systems costs, including the need for multiple different systems and systems implementation specifically designed to address regulatory divergence.
- Restructuring compliance department to better adjust to regulatory divergence.
- Costs of external consultants to help deal with regulatory divergence.

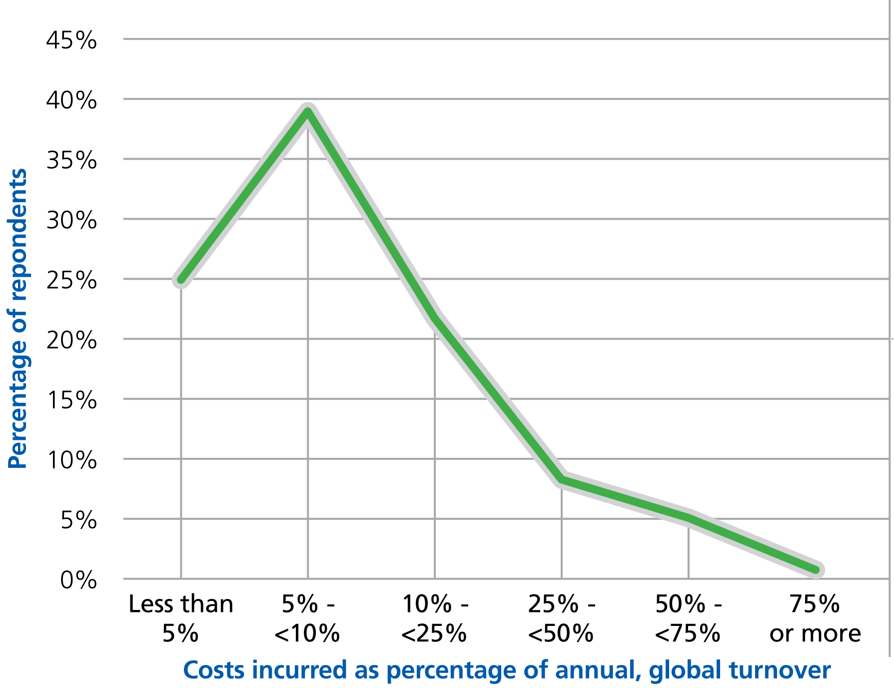
"Now we need more people in compliance who can oversee local and global legislation and regulatory procedures."

– Insurance Compliance Officer, Canada

"Additional training is needed for our people to deal with various regulations related to different geography and respective laws."

– Professional Services Risk Management Officer, India

FIGURE 1 | COSTS INCURRED DUE TO REGULATORY DIVERGENCE BETWEEN JURISDICTIONS



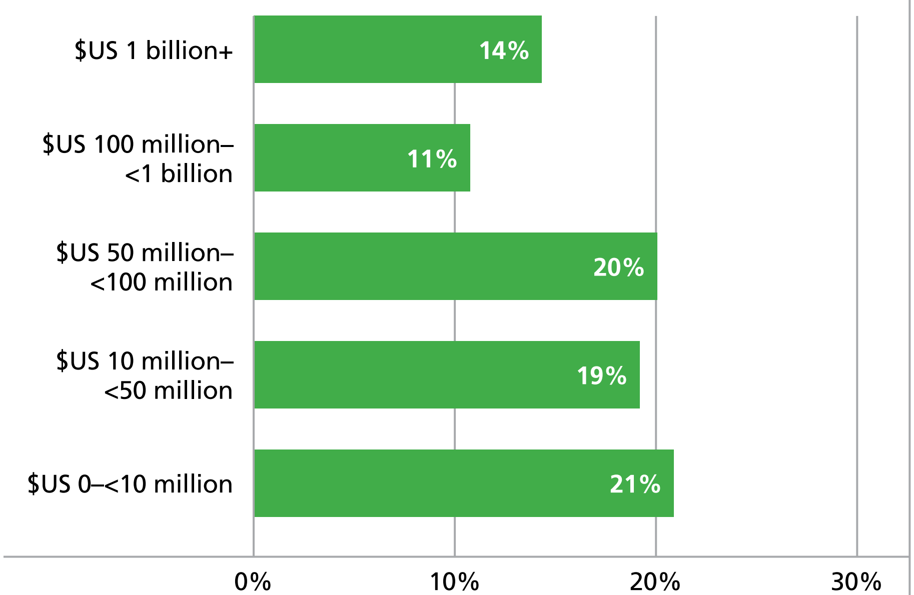
Direct and indirect costs incurred when regulations are opaque and information regarding requirements that are divergent across different jurisdictions is difficult to acquire.

REGULATORY DIVERGENCE: COSTS

RESPONDENTS IN SMALLER ORGANIZATIONS WERE MORE LIKELY TO INDICATE THAT THE COSTS INCURRED AS A RESULT OF DIVERGENT REGULATIONS WERE MATERIAL OR VERY MATERIAL TO THEIR INSTITUTION'S OVERALL FINANCIAL PERFORMANCE AND CONSUMED A LARGER PROPORTION OF THEIR INSTITUTION'S ANNUAL TURNOVER.

- Regulatory divergence costs were most material for respondents whose institutions are impacted significantly by competition law, and those focused on the capital markets sector.

FIGURE 2 | COSTS OF REGULATORY DIVERGENCE FOR SMALLER AND LARGER INSTITUTIONS



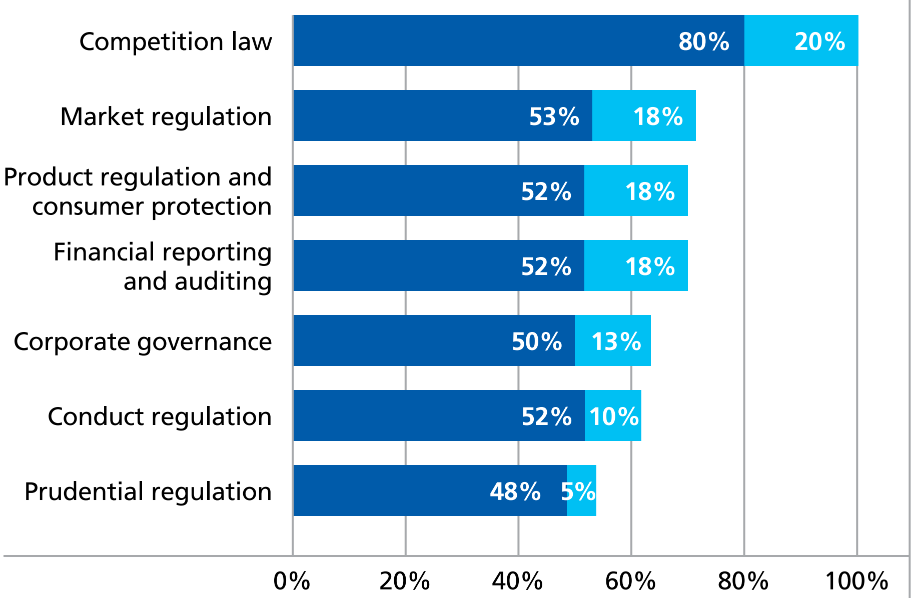
"A multiplication of required indicators, as well as reporting and audits for multiple supervisory authorities are increasing costs."

–Banking Risk Management Officer, France

Respondents from smaller organizations were more likely to find the costs of dealing with divergent regulation are very material to their institution's financial performance (Figure 2 shows percentage of respondents who indicated costs incurred by their institution are very material when regulations are opaque and information regarding requirements that are divergent across different jurisdictions is difficult to acquire, by annual turnover of organization).

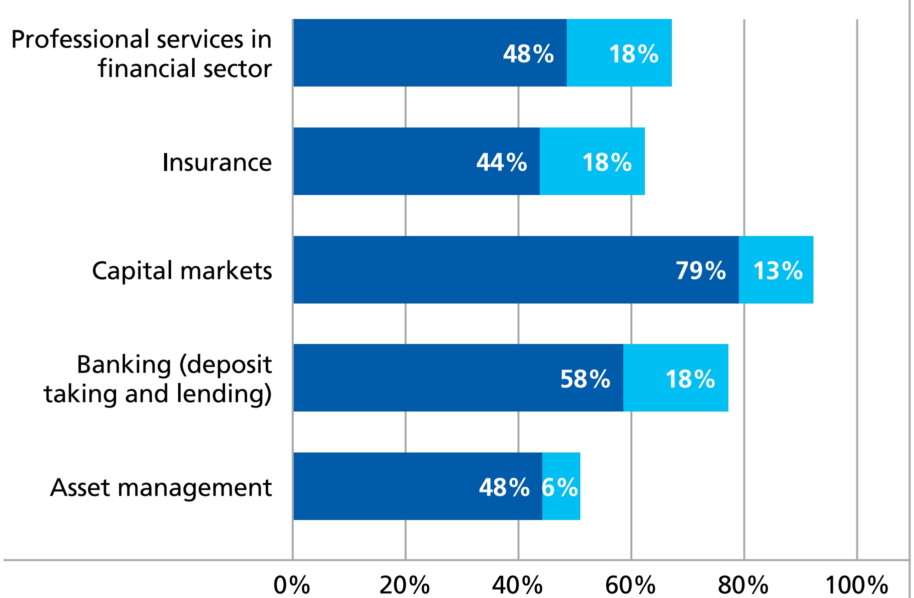
REGULATORY DIVERGENCE: COSTS

FIGURE 3 | COSTS OF REGULATORY DIVERGENCE ASSOCIATED WITH DIFFERENT TYPES OF REGULATION



Respondents indicating that competition law is the regulatory area with the greatest impact on their institution were most likely to find the costs associated with regulatory divergence are material or very material to their institution’s performance (Figure 3 shows materiality of costs incurred when regulations are opaque and information regarding requirements that are divergent across different jurisdictions is difficult to acquire by type of regulation.

FIGURE 4 | MATERIALITY OF THE COSTS OF REGULATORY DIVERGENCE BY SECTOR



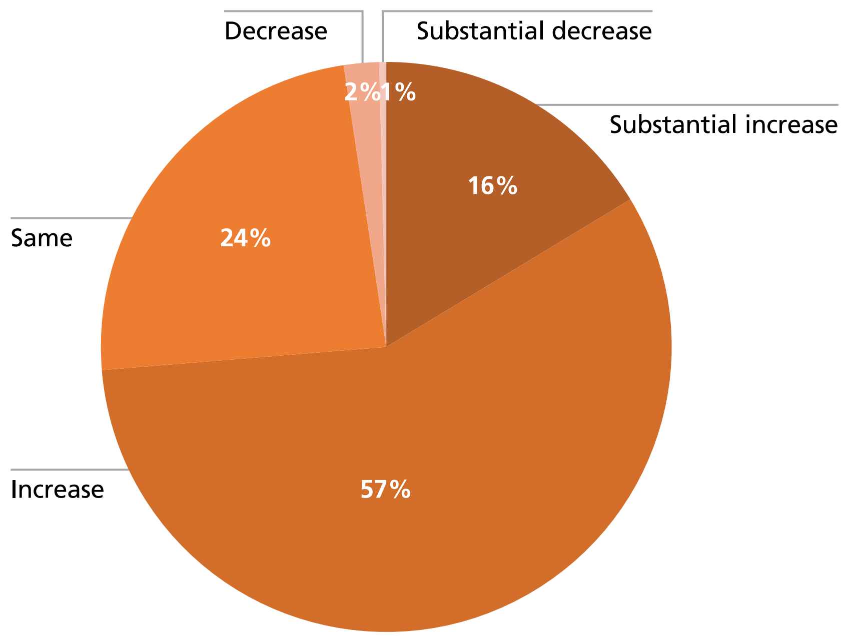
Respondents in the capital markets sector were most likely to find the costs associated with regulatory divergence are material or very material to their institution’s performance (Figure 4 shows materiality of costs incurred when regulations are opaque and information regarding requirements that are divergent across different jurisdictions is difficult to acquire by sector).

REGULATORY DIVERGENCE: COSTS INCREASING

73% OF RESPONDENTS REPORTED AN INCREASE OR SUBSTANTIAL INCREASE IN COSTS RELATED TO DIVERGENT REGULATION OVER THE PAST FIVE YEARS.

- 65% of respondents expect further increases or substantial increases over the coming five years.
- Respondents mainly pointed to regulations introduced in response to the 2008 financial crisis and competition legislation in regard to increases in costs related to regulatory divergence over the past five years. Brexit and protectionist politics were raised in regard to expected increases in costs over the coming five years.

FIGURE 5 | DID THE COST TO YOUR INSTITUTION RELATED TO DIVERGENT REGULATION INCREASE OR DECREASE OVER THE PAST 5 YEARS?



"With increasing uncertainty surrounding Brexit, we anticipate increased costs arising from divergent United Kingdom and European Union regulations within my industry."

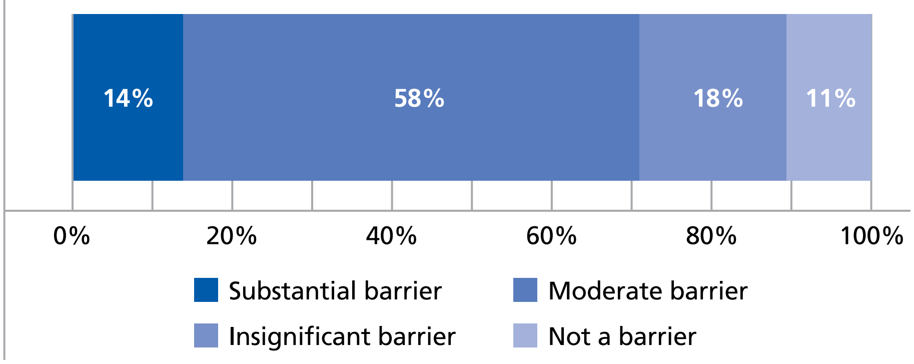
– Banking Management Board Member and C-Suite Executive, UK

REGULATORY DIVERGENCE: IMPACTS ON GROWTH AND RISK

51% OF RESPONDENTS INDICATED THAT THEIR INSTITUTION HAD LESS RESOURCES TO INVEST IN RISK MANAGEMENT DUE TO DIVERGENT REGULATION DURING THE PAST 5 YEARS.

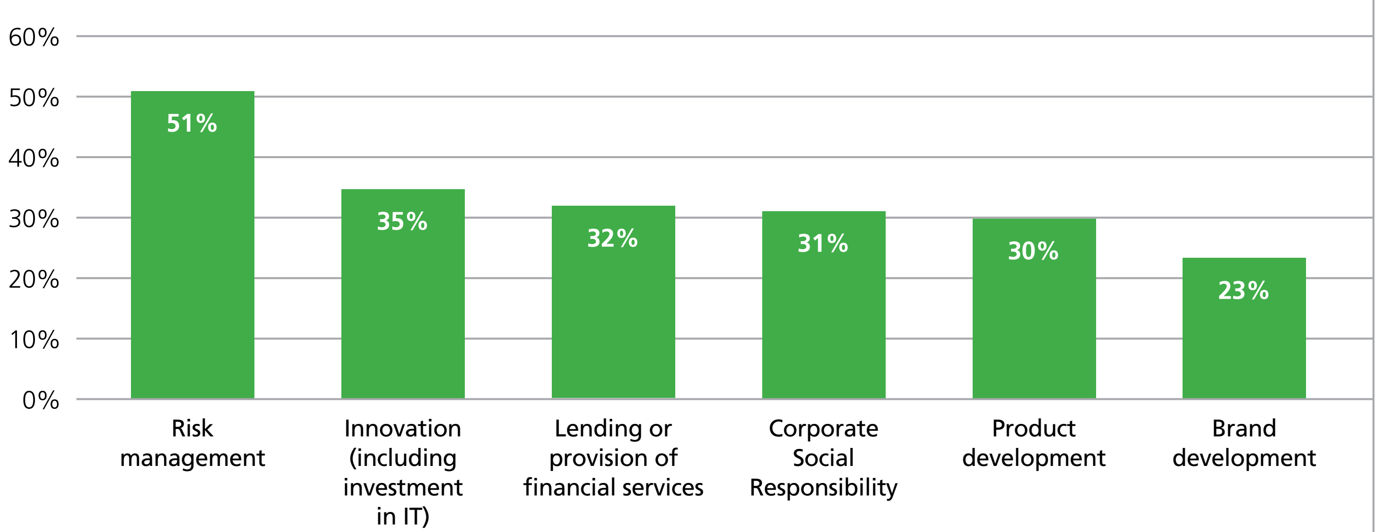
- Respondents also reported impacts on investment in innovation, lending activities, corporate social responsibility, product development, and brand development.
- 71% of respondents indicated that regulatory divergence was a moderate to substantial barrier to their institution extending operations into new regions.
- Respondents indicated senior management time and capital are being consumed in dealing with regulatory divergence instead of focused on activities geared toward identifying and addressing emerging risks in the financial system.

FIGURE 6 | **TO WHAT EXTENT HAS REGULATORY DIVERGENCE BEEN A BARRIER TO YOUR ORGANIZATION EXTENDING ITS OPERATIONS TO REGIONS IN WHICH IT DOES NOT PRESENTLY OPERATE?**



"We had to restructure our department."
–Banking Head of Business, Germany

FIGURE 7 | **DID YOUR ORGANIZATION HAVE TO PRIORITIZE SPENDING ARISING FROM DIVERGENT REGULATION OVER ANY OF THE FOLLOWING FORMS OF INVESTMENT OVER THE PAST 5 YEARS?**

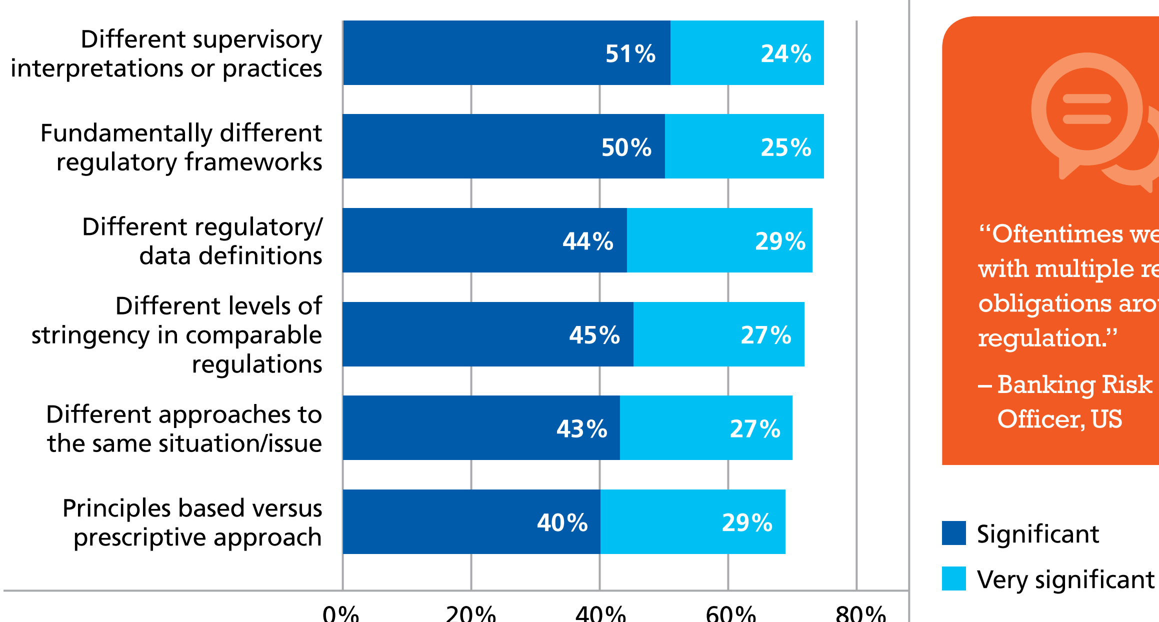


REGULATORY DIVERGENCE: TYPES

THREE QUARTERS OF RESPONDENTS INDICATED SIGNIFICANT TO VERY SIGNIFICANT INCONSISTENCIES IN REGULATION BETWEEN JURISDICTIONS IN WHICH THEIR INSTITUTION OPERATES.

- 76% of respondents indicated the inconsistencies arising from different supervisory interpretations or practices between different jurisdictions are significant or very significant.
- Respondents also indicated significant or very significant inconsistencies arising from fundamentally different regulatory frameworks, different regulatory or data definitions, different levels of stringency and regulations, and different approaches to the same regulatory situation/issue.
- Respondents indicated several specific issues that, despite a degree of overall consistency in the approach to regulation internationally, result in significant regulatory divergence including:
  - Duplicative reporting requirements.
  - Varying and sometimes contradictory interpretations associated with monitoring and enforcement of regulations.
  - Divergence in the detail of regulatory definitions.
  - Adoption of internationally agreed reforms at varying speed in different countries, and with different levels of stringency.
  - Overall lack of clarity in rules and regulations.

FIGURE 8 | HOW SIGNIFICANT ARE THE FOLLOWING TYPES OF INCONSISTENCIES IN REGULATION BETWEEN JURISDICTIONS IN WHICH YOUR ORGANIZATION OPERATES?



"Product based definitions can be similar, but not the same, resulting in differing standards."

– Banking Compliance Officer, Canada

"There are specific instances where the regional regulatory interpretation is not consistent with the global standard, resulting in substantial implementation challenges and costs."

– Banking Risk Management Officer, China

"Oftentimes we're dealing with multiple reporting obligations around the same regulation."

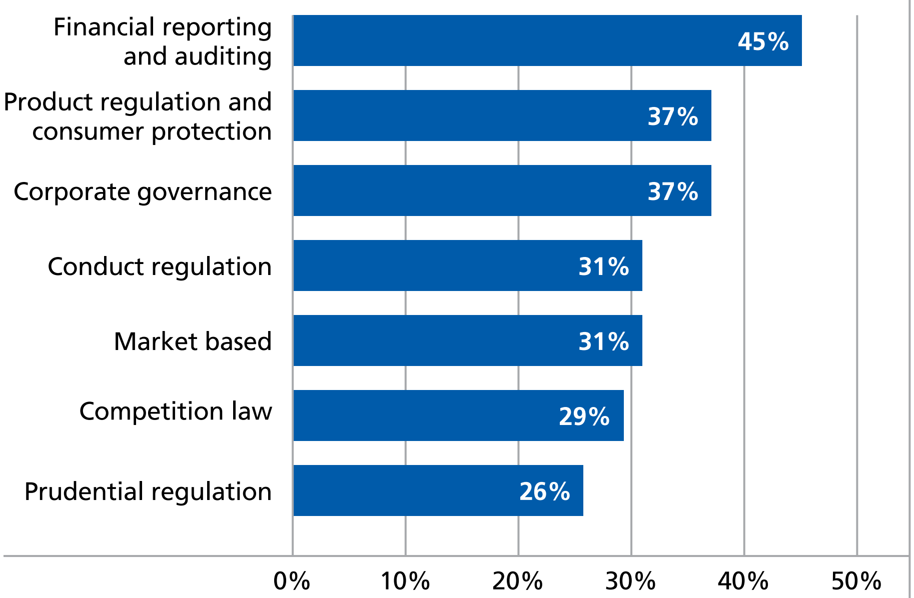
– Banking Risk Management Officer, US

REGULATORY DIVERGENCE: TYPES

"There is gradual regulatory consolidation, but likely that there will be various possible options and interpretations in the difficult details."

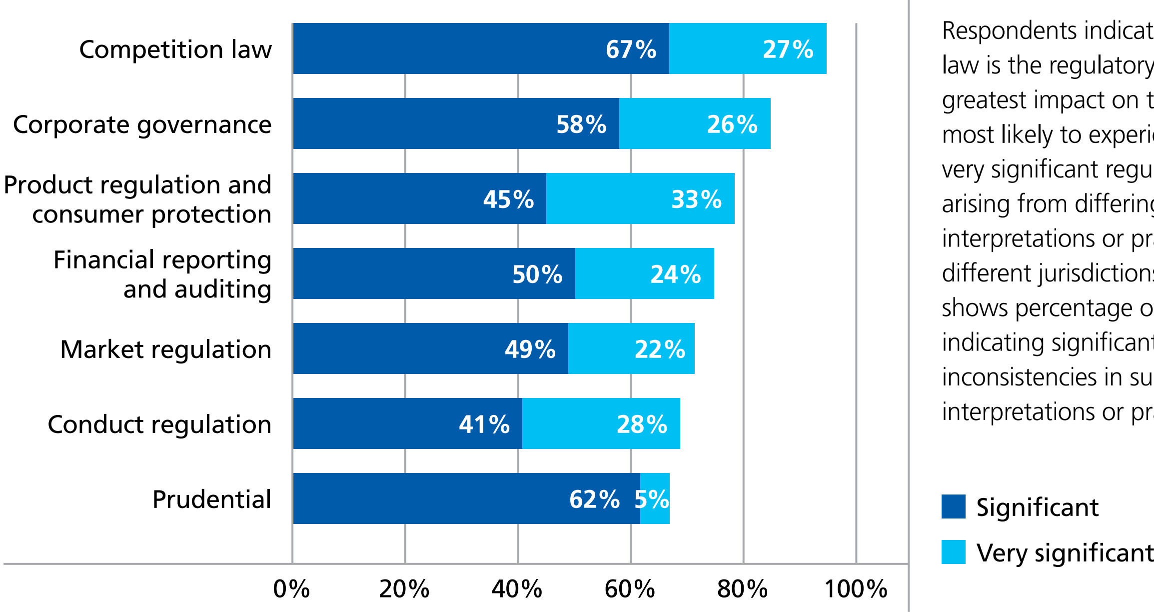
– Insurance Risk Management Officer, Germany

FIGURE 9 | A DEGREE OF CONSISTENCY IN THE OVERALL APPROACH...



Despite regulatory divergence arising from different supervisory interpretations or practices between different jurisdictions, and other issues associated with monitoring and enforcement, some respondents indicated a degree of consistency in the overall approach to regulation internationally (Figure 9 shows percentage of respondents indicating the overall approach to these regulations is very consistent).

FIGURE 10 | DIVERGENCE ARISING FROM DIFFERING SUPERVISORY INTERPRETATIONS OR PRACTICES



Respondents indicating that competition law is the regulatory area with the greatest impact on their institution were most likely to experience significant or very significant regulatory divergence arising from differing supervisor interpretations or practices between different jurisdictions (Figure 10 shows percentage of respondents indicating significant or very significant inconsistencies in supervisor interpretations or practices).

REGULATORY DIVERGENCE: SOLUTIONS

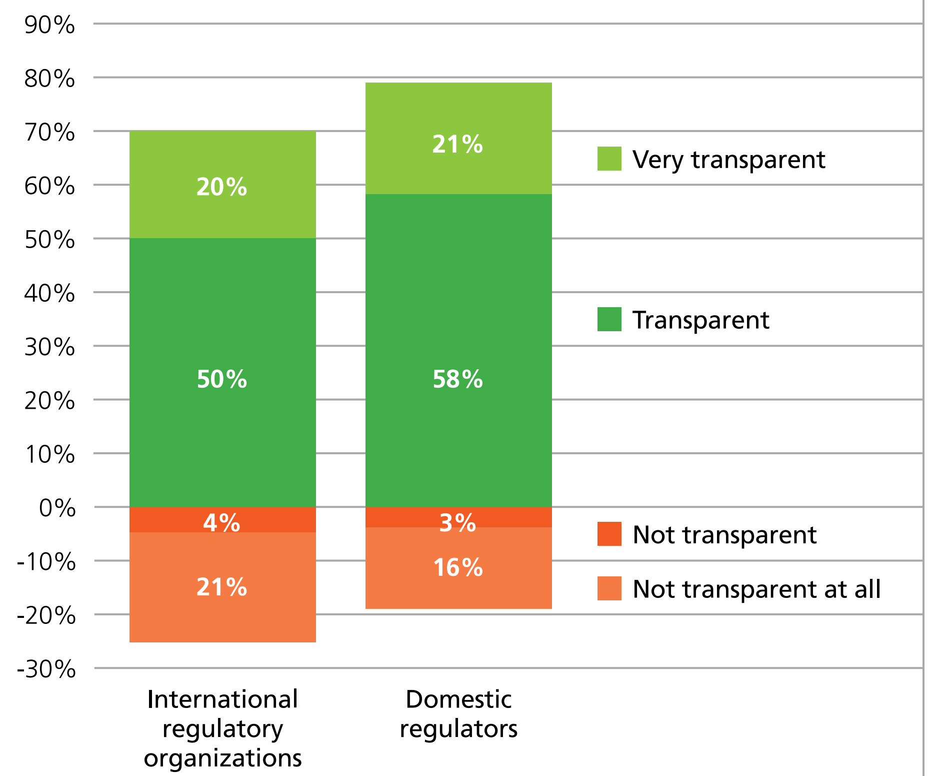
Respondents recommended regulators and international organizations could better address the impacts and costs of regulatory divergence by:

- Enhancing international cooperation among regulators, including in how regulations are interpreted, monitored and enforced, and exchanging information between regulators.
- Increasing overall alignment in rules, regulations and standards; and increasing adherence to global standards.
- Improving alignment in regulatory definitions internationally.
- Increasing awareness of how other regulators are enforcing and monitoring regulations in order to avoid duplicating reporting requirements and processes.
- Enhancing transparency by international organizations in developing new rules and regulations.
- Developing greater clarity in rules and regulations.

"Self-policing by regulators to minimize differences would help companies trying to operate in more than one jurisdiction."

– Banking Risk Management Officer, US

FIGURE 11 | TRANSPARENCY IN SETTING REGULATION – INTERNATIONAL VERSUS DOMESTIC



Respondents perceive a greater degree of transparency from domestic regulators, than international regulatory organizations in processes for developing new or revising existing regulations.

ABOUT THIS STUDY

251 compliance/risk management officers and senior leaders (management board, c-suite and heads of major functions) in the financial sector surveyed during July and August 2017.

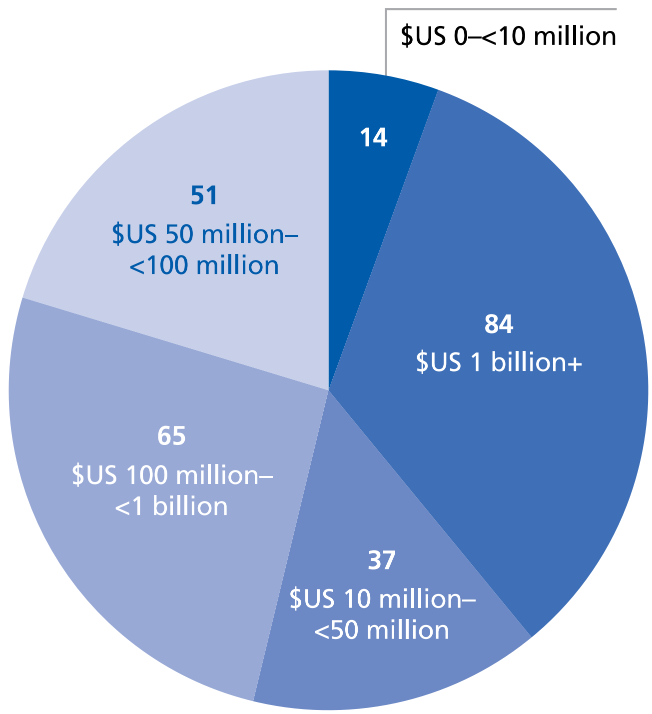
Respondents' institutions ranged in size from less than $US10 million to more than $US1 billion and from less than 500 employees to more than 10,000 employees.

Respondents were located across Australia, Austria, Belgium, Brazil, Canada, China, France, Germany, India, Japan, Mexico, Netherlands, Spain, United Arab Emirates, the United Kingdom, and the United States. Their institutions' operations span jurisdictions throughout Africa, the Americas, Asia, Europe, the Middle East, and Oceania.

Sectors represented include capital markets, banking (deposit taking and lending), asset management, insurance, and professional services.

The main regulations impacting respondents' institutions are in the areas of prudential, financial reporting and auditing, corporate governance, conduct, market based regulation, product regulation/consumer protection and competition.

FIGURE 12 | RESPONDENTS' INSTITUTIONS' SIZE (ANNUAL TURNOVER)



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