APPENDIX C

Major Legislative and Regulatory Developments

A. Introduction and Summary

A central ingredient contributing to the context and perspective for the CRMPG II project relates to the changing supervisory and regulatory environment within which financial intermediaries conduct their business. Accordingly, as a part of the background material assembled for the project, a broad and high level survey of major supervisory and regulatory developments over the period since the publication of CRMPG I was conducted.

The survey covered major developments in the following areas: (1) Structural Developments, (2) Prudential Developments, (3) Compliance and Control Developments, and (4) Accounting Developments. In each of these areas, there have been profoundly important changes in both philosophy and policy. While the direction of these changes in policy are both understandable and broadly appropriate, the sheer magnitude and complexity associated with the cumulative weight of so many changes in such a short period of time constitutes a major challenge for both the official and private sectors. Several of those challenges are highlighted below.

1. Principles versus Rules

Virtually all areas of supervisory, regulatory and accounting policy are drifting into an environment in which rules are gradually displacing principles — a trend which will be very difficult to reverse. The Basel II capital regime, accounting standards, prescriptive compliance related regulations and the acute information overload problem associated with public disclosure requirements are all illustrations of situations in which basic principles are being displaced in the name of rules. Of particular concern are situations where new standards are effectively first imposed through enforcement actions. In some situations, this creates a situation where financial intermediaries must operate for a period of time without the necessary level of regulatory guidance regarding the specific contours of the new standard.

More generally, the trend toward detailed rule-making reflects a tension that is seen in both the public and private sectors, whereby the perceived need on the part of accountants, lawyers and regulators to anticipate virtually all contingencies produces so much detail as to make it difficult for managers to manage and supervisors to supervise. Even worse, the focus on detail inevitably can create incentives for practitioners to arbitrage the system, thereby producing the need for still more detail.

One area in which this trend can be checked relates to the prudential supervision of so-called large and complex financial institutions where greater reliance on the application of Basel II, Pillar Two in a risk sensitive manner holds promise of a return to a more principles-based approach. In fact, in this area movement in the desired direction is already occurring. Also, greater progress in a principles-based supervisory approach in this area could point to other areas in regulatory and/or accounting policy where principles might play a larger role.

2. Division of Responsibilities between Intermediaries and their Clients

In the aftermath of corporate and financial scandals, there has been a tendency to prescribe in some detail the responsibilities of financial intermediaries regarding structured products sold to their clients even when the client is unambiguously a sophisticated institutional client. Few would dispute that it is critical for financial intermediaries to maintain high standards of internal control and discipline relating to client/counterparty relationships. Moreover, virtually no observer would dispute the assertion that we have seen examples in recent years where financial institutions were not as rigorous as they should have been in managing client relationships.

Financial intermediaries have taken steps to strengthen their policies and practices in this area. The larger question, however, is the danger — however small — that efforts to spell out in detail the responsibilities of the intermediary could undermine the historic and delicate balance of responsibilities between intermediaries and their clients. Clearly, there is a point where sophisticated clients in particular must take responsibility for their own actions. This balancing of responsibilities and obligations between financial institutions and their institutional clients has been one of the great strengths of the financial system for centuries.

Nothing said above should be seen as suggesting that financial intermediaries should not have clear and high standards of responsibilities in managing their relationships with both retail and institutional clients. Indeed, Sections V and VI of this Report contains meaningful guidance as to heightened standards that should better and more rigorously guide the relationship between intermediaries and both their retail and institutional clients while at the same time assisting all parties to financial transactions toward meeting their underlying economic objectives.

3. Harmonization of Accounting Standards and Risk Management

There is a clear need to accelerate the national and international harmonization of accounting, regulatory and disclosure requirements and to ensure their alignment with proper risk management incentives. The differences between the bases on which financial firms measure financial instruments for risk management purposes, for regulatory capital purposes and for reporting to shareholders under GAAP can produce unintended and perverse risk management incentives, and also contribute to costly and confusing financial statements. Thus, accounting authorities must continue and intensify their efforts to harmonize international standards and work with regulators with the ultimate aim of reducing the differences between accounting and regulatory capital treatment of the same product. Consideration should be given to the establishment of a single, common forum at which such issues could be promoted. Needless to say, such efforts must also strive to resolve the long standing disputes about the application of fair value accounting to financial instruments.

4. Regulatory Coordination and Convergence

The financial system as a whole would benefit from more coordination and convergence among regulators in different jurisdictions on key issues (e.g., Basel II, home/host issues, etc.). Successful implementation of global standards depends importantly on the degree of coordination among national authorities and regulated institutions. Without such greater coordination, there is an increased risk of differing application of standards which could lead to issues of competitive inequality or arbitrage opportunities as regulators exercise different interpretations of standards. The need for regulatory coordination and

convergence also extends to the inherent tensions that can exist between so-called umbrella (or consolidated) supervisors and functional supervisors.

The financial services industry welcomes and encourages strong cooperation among the regulators, including the state securities regulators in the US. To the extent practicable, the goal should be the development of one set of standards concerning a particular functional regulatory area that would apply across national boundaries. In brief, the challenge is to develop a more holistic approach to regulation so that firms can follow global principles of conduct and develop procedural protocols to fulfill global regulatory requirements. This, in turn, will enhance global regulatory oversight of firms and contribute to the goal of financial stability.

B. Survey

1. Structural Developments

Since 1999, the financial industry has seen an increase in globalization and consolidation. As the lines between traditional bank and securities activities have become increasingly blurred, institutions are engaging in a wider range of services, offering more similar products and competing in the same markets. Some laws, such as the US Gramm-Leach-Bliley Act of 1999 (GLBA) and the EU Financial Services Action Plan (FSAP) have facilitated this trend, while others, such as the EU Financial Conglomerates Directive (FCD), have been enacted largely to respond to the rise of these so-called large and complex financial services institutions.

GLBA repealed the provisions of the Bank Holding Company Act and the Glass-Steagall Act that prevented affiliations among banks, securities firms and insurance companies, allowing US financial firms to engage in the same range of financial services that European regulation already permitted. To regulate these conglomerates, GLBA introduced the concept of a financial holding company (FHC) and placed the Federal Reserve (Fed) in charge of consolidated supervision of such holding companies. Underneath the holding company, the Fed is to rely on the existing functional regulators, such as the Securities and Exchange Commission (SEC), for information about securities affiliates and insurance regulators for insurance activities.

In the six years since its enactment, banks have been the primary entities electing FHC status; to date, there have been only a handful of non-bank institutions that have opted for FHC status, none of which are the major US investment banks. While bank holding companies (BHCs) were already subject to Fed supervision, securities firms would have to apply to become a BHC and FHC simultaneously. This would entail complying with Fed regulations as well as activity limits that investment banks are not subject to currently. However, as discussed below, these large investment banks are in the process of adapting to a framework of consolidated supervision.

The FCD, which came into effect for firms' financial years beginning January 1, 2005, has advanced the concept of consolidated supervision by introducing new capital and supervisory requirements for financial conglomerates operating in the EU. The purposes of the FCD are to enhance the prudential soundness of large financial groups operating across financial sectors and across borders, and to prevent an excess concentration of risk within a conglomerate through greater monitoring of intra-group capital and funding flows.

The FCD requires conglomerates whose head office is outside the EU to apply Basel capital standards and to be subject to "equivalent" home country consolidated supervision at the holding company level. Absent a determination of equivalence, the FCD calls for: (1) an EU regulator to assume the role of consolidated supervisor, extending European requirements to the worldwide group; or (2) other approaches designed to achieve similar oversight, such as mandating the formation of an EU sub-holding company to ring-fence operations and to limit intra-group exposures between EU and non-EU entities.

In response to the FCD, since US securities holding companies were not subject to consolidated supervision, the SEC put forth a rule whereby investment banks can apply to become a "consolidated supervised entity" (CSE). The voluntary CSE rule, adopted by the SEC in June 2004, is designed to permit certain broker-dealers to utilize an alternative method of computing capital. As a condition to using this alternative method, a broker-dealer's ultimate holding company must consent to group-wide SEC supervision, including examination of any affiliate that does not have a principal functional regulator. Once approved, the holding company must perform a Basel-like capital calculation. Any of these options entails the final approval of the primary or lead EU regulator, who makes

an equivalency determination on a firm-by-firm basis. To date, two US securities firms have applied for, and have been granted, CSE status and several additional firms have applications pending.

In 1999, the European Commission embarked upon the FSAP, an extensive work program of proposals designed to complete a single European financial services market. The FSAP identified a number of key strategic objectives including: (1) the creation of a single wholesale market, (2) open and secure retail markets, and (3) state-of-the-art prudential rules and supervision (e.g., the FCD).

For wholesale markets, the FSAP has sought to create a single EU market by:

- Establishing a common legal framework for integrated securities and derivatives markets, effectively allowing cross-border provision of investment services.
- Removing outstanding barriers to raising capital on an EU-wide basis (i.e., national rules that hinder offering securities in other Member States).
- Establishing a single set of reporting requirements for listed companies (i.e., International Financial Reporting Standards or IFRS) so that companies can raise capital throughout the EU using one set of financial statements.
- Creating a secure and transparent environment for cross-border mergers, including directives intended to organize corporate legal structures more rationally in the single market.

Of the 42 original FSAP measures identified, 39 have been adopted. The determination of whether the FSAP has achieved its stated objectives depends on the implementation and enforcement of all measures.

In Japan, the concept of a financial holding company was introduced in March 1998, enabling a commercial bank, a securities company and an insurance firm to operate as a financial group with certain transactional and information flow constraints due to firewall regulations. In the same year, under the Prime Minister's office, the Japan FSA was created to supervise private-sector financial institutions and to provide surveillance of securities activities. In 2000, the Japan FSA also assumed the responsibilities for policy making, which was transferred

from the Ministry of Finance. Accordingly, the Japan FSA now has a full range of regulatory authority over the financial industry — from policy making to supervision and inspection.

In 2004, the Japan FSA announced the "Program for Further Financial Reform." As one of the program agenda items, the Japan FSA is studying the "Investment Service Law," which is designed to be a comprehensive regulation applicable to investment products across the financial services industry segments (commercial banks, securities firms, insurance companies) from the perspective of private investor protection. The basic outline of the law is still under discussion and is expected to be enacted sometime in 2006.

The Japan FSA is also studying how regulations should be changed to deal with financial conglomerates. As an initial step of this initiative, guidelines for the supervision of financial conglomerates are expected to be implemented in July 2005. There will be further discussions about this subject over the next year and more regulatory or legislative measures are anticipated to be formulated in 2007. These initiatives may have a significant impact on the regulatory framework and may promote integration and conglomeration of financial institutions in Japan.

In December 2004, the Japan FSA also revised the Trust Business Laws. Major changes include: (1) the removal of a restriction that a trust company must be a bank, thus allowing non-financial institutions to be registered with the Japan FSA as a trust company; and (2) the introduction of an agency branch system for a trust business to facilitate investor access to trust products.

Currently, the Securities and Exchange Surveillance Commission (SESC) has inspection power over a securities company with respect to the fairness of sales and trading, while the Japan FSA has authority over the inspection of financial soundness and risk management. From July 2005, the audit function of the Japan FSA with regard to its financial soundness and risk control is expected to be transferred to the SESC, and the SESC will become a unified inspector for a securities company.

2. Prudential Developments

The most groundbreaking prudential development in the past six years has been the advancement of capital standards through the Basel Committee on Banking Supervision's revised capital adequacy guidelines. *International Convergence of*

Capital Measurement and Capital Standards: a Revised Framework (or Basel II) was published in June 2004, five years after efforts to update the original 1988 Basel Accord (Basel I) began, indicating the difficulty of the task.

The 1988 Accord focused primarily on credit risk. A capital charge for market risk was subsequently added to Basel I through the implementation of the 1996 Market Risk Amendment (MRA), which paved the way for adopting VAR as the primary basis for market risk capital requirements.

Basel II is based upon three pillars: (1) minimum capital requirements (measures of credit risk, market risk and a new operational risk charge); (2) supervisory review; and (3) enhanced market discipline by means of substantial additions to public disclosure requirements. The goal of Basel II is to align regulatory capital with economic capital by developing a risk-sensitive framework that is reflective of how institutions run their businesses. Under Basel I, credit risk capital charges generally do not differ by degree of economic risk. Among Basel II's most innovative aspects are the internal ratings-based (IRB) approaches to credit risk where, for the first time, institutions will be allowed to use their internal credit systems to quantify key measures of a borrower's creditworthiness including: the probability that an obligor will default, the firm's exposure at default and the loss rate in the event of a default. Thus changes in a firm's assessment of a borrower's credit quality will be reflected in its capital requirements. As firms refine their risk assessment capabilities, they will be able to more closely align these measures of risk with their economic capital allocation. As noted above, Basel II capital requirements will prospectively apply to US securities firms that are granted "consolidated supervised entity" status by the SEC.

While the process leading to the implementation of Basel I has been underway for a number of years, there still is some uncertainty about some of its details and the final implementation time schedule. Indeed, only recently the US bank regulatory agencies indicated that they will further delay the formal Notice of Proposed Rulemaking for Basel II due to concerns that arose in connection with firms' estimates of Basel II capital charges that surfaced in the agencies' fourth quantitative study of the impact of the new capital standards.

More broadly, while most observers fully accept the view that Basel I was badly outdated and that a more risk-sensitive approach to setting capital requirements was needed, there remain a few concerns about the overall Basel II framework.

One such concern relates to the complexity (and cost) of Basel II, including the risk that such complexity may lead to behavioral changes by banks that are difficult to anticipate as institutions seek to economize on capital charges. There is also the concern that the cyclical behavior of both internal and external credit ratings might introduce a pro-cyclical bias into capital charges that might exaggerate credit cycles. Additionally, among different classes of institutions — both nationally and internationally — there are questions about the competitive impact of Basel II, especially since national banking supervisors may have greater flexibility in applying the rules than is the case with Basel I.

Finally, the significant difference in the capital treatment of the same asset depending on its classification as either trading or "available for sale" has been a matter of some concern. Basel II was designed by bank regulators to address the capital requirements for assets held principally for purposes other than trading, since the treatment of trading assets was addressed in the 1996 MRA. Securities firms have advocated revisiting the MRA to ensure that capital treatment under Basel II is risk-reflective and not a function of where an asset lies on the balance sheet. A joint working group comprised of the Basel Committee and the International Organization of Securities Commissions (IOSCO) is working on this issue. The working group published a proposal for industry comment in April 2005 addressing a number of issues, such as the management of counterparty credit risk for OTC derivatives and repo-style transactions, double default, specific risk and cross-product netting. The working group intends to publish the final rules in mid-July 2005 so that they can be incorporated into, and adopted along with, the rest of the Basel II framework.

Notwithstanding these open questions about Basel II, the overwhelming majority of financial practitioners believe that the quality and effectiveness of prudential supervision has improved and will improve further under Basel II. Indeed, the continuing shift to more risk sensitivity and greater emphasis on the quality of risk management, control, credit-related and internal audit systems are widely seen as positive steps that encourage a more far-reaching and constructive dialogue between individual institutions and their regulators.

On the other hand, the extent of supervisory coordination remains a concern. Although the Basel Committee created the Accord Implementation Group (AIG) to identify different implementation approaches and to try to clarify the role of

home and host country supervisors, it remains to be seen the extent to which supervisors will work with one another to minimize duplicative validation work. In Europe, the Committee of European Banking Supervisors (CEBS) has a mandate similar to that of the AIG, with the distinction that it has legal authority. As such, at least in Europe, the CEBS may have a better chance of generating a degree of commonality in implementation among EU supervisors. These issues associated with coordination between so-called "umbrella" supervisors and functional supervisors, as well as those between home and host country supervisors, are seen as a major challenge for the future.

3. Compliance and Control Developments

In the US in particular, but in other jurisdictions as well, we have witnessed over the last several years a surge of new compliance and control related legislation, administrative rule-making, enforcement actions and civil and criminal proceedings that are perhaps without precedent in the post-war period. This surge of activity is an understandable response to headline-creating corporate scandals, abuse and alleged fraud that has surfaced in a relatively small — but still alarming — number of institutions, including a few of the most prominent corporate names. Moreover, whether it is reasonable or not, many of these unfortunate situations are seen by the public as having their roots, at least in part, on "Wall Street." Indeed, whether it was the so-called Global Research Settlement, problems at mutual funds and insurance companies, apparent failures on the part of large integrated financial intermediaries in managing potential conflicts of interest or the apparent need for more effective management in respect of complex and highly structured financial products, financial institutions are seen by many observers as being at or near the center of scandal-driven financial storms of recent years.

At the risk of great oversimplification, the major compliance and control related initiatives of the past few years fall into several broad categories as follows: (1) changes in governance standards, most notably the various requirements of the Sarbanes-Oxley Act of 2002; (2) increased regulatory focus on management of potential conflicts of interest; (3) broadened responsibilities on the part of financial intermediaries regarding the design of complex structured products sold to their clients, even when the client is unquestionably a sophisticated institution; (4) enhanced disclosure requirements; (5) the "know your customer" and related

requirements of the USA Patriot Act; and (6) the effort to extend official oversight to hedge funds.

The details associated with the initiatives listed above are well-known and need not be repeated here. More broadly, few, if any, leaders of the corporate community in general and leaders of financial institutions in particular would take exception with the view that the abuses of the recent past demanded reform. As in all endeavors, however, the reform process must strike a reasonable balance that helps to guard against future problems while also preserving and protecting those traits of the financial system which are the source of its creative and competitive genius.

As an example, financial institutions should, and are, engaging in significant efforts to enhance their global compliance and operational risk management programs so as to protect against reputational risk. This is an important endeavor from both a compliance and prudent business management perspective. However, any reform process should, to the extent practicable, take into account the desirability of harmonizing global functional regulation. Particularly as a result of the compliance and control related developments over the past several years, divergence in functional regulation is more evident. This can present significant challenges for global financial services firms doing business in today's markets with today's products that often cut across jurisdictional boundaries. Divergence in functional regulation is reflected in a myriad of different ways. We can observe multiple functional regulators around the globe with somewhat differing approaches to solving regulatory problems, such as rules-based versus principles-based regulation and supervisory versus enforcement approaches. By way of example, the EU regulators, the US regulators and the Japanese regulators approach similar issues, but do so pursuant to a number of different institutional settings, legal constructs and styles. As underscored in the summary, convergence in functional regulation will enhance global regulatory oversight of firms and contribute to the goal of financial stability.

As another example, financial institutions should, and are, improving the care and diligence with which they enter into complex structured products with their clients. However, there is a danger — however small — that regulatory developments might alter the balance of responsibilities between clients and

financial services firms. This potential concern was highlighted by the proposed statement regarding sound practices regarding complex structured finance activities issued on May 13, 2004 by various federal agencies including the Fed and the SEC. A joint industry association comment letter dated July 19, 2004 on the proposed statement raised a number of key concerns regarding the inter-agency public comment proposal. At the heart of those concerns was the issue of whether the proposals went too far in defining the responsibilities of financial intermediaries in regard to such transactions when counterparties also have inherent responsibilities for their own care and diligence.

4. Accounting Developments

In the past few years, progress has been made in harmonizing international and US standards. In October 2002, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) signed a Memorandum of Understanding committing to efforts to make financial reporting standards compatible. Besides offering international firms prospective relief from the burden of reconciling their financial statements to local standards, convergence would increase consistency and transparency, enabling market participants to evaluate companies based on the same standards. In practice, this agreement requires the two groups to align their agendas and to revise existing standards in tandem, with the objective of progressively reducing the differences. A major conceptual difficulty in pursing this objective is that US GAAP is a rules-based regime, whereby IFRS attempts to be principles-based.

Although IASB and FASB are working to reduce differences, the benefits of harmonization are substantially diminished if multiple GAAP presentations and reconciliations are still required. In April 2005, the SEC stated that it may remove the requirement for listed foreign companies using IFRS to reconcile their financial statement to US GAAP by 2007. The Committee of European Securities Regulators (CESR) made a similar recommendation for companies using US, Canadian or Japanese standards, but called for additional disclosures in some areas. Even if these steps toward harmonization occur as contemplated, however, vast differences in accounting regimes will remain both in philosophy and substance within and across countries in a setting in which the incidence of apparent abuse increases pressures for still more rules. At the

same time, the sometimes bitter debate over fair value versus historic cost accounting for financial instruments has yet to be resolved.

In recent years there has been much debate surrounding the application of fair value to financial instruments. In a so-called mixed model accounting framework, instruments are valued either on an historical cost less impairment basis (banking book) or on a fair value basis (trading book). A 2003 report by the Group of Thirty, *Enhancing Public Confidence in Financial Reporting*, crystallized three different viewpoints on the application of fair value:[28]

> *"First, the view broadly associated with banks and many bank regulators is that some financial instruments, particularly the book of loans carried by banks (especially loans to consumers and small businesses) are not suited to fair valuation and the traditional approach — historical cost less provision for incurred impairment — should be maintained. The Basel Committee and the Fed have cautioned against a move to comprehensive fair valuation without resolving significant implementation issues or providing rigorous guidance on valuation of such financial instruments. This view opposing fair value accounting for bank loans is based on three assertions: first, the relevance of historical cost valuations to the lend-and-hold to maturity philosophy that has characterized bank lending for decades; second, the practical difficulty of valuing loans when most do not have readily observable prices; and third, potentially perverse incentives, especially a short-term orientation to risk taking, that could result from fear of greater volatility in reported profits. It is argued that this last factor could have important systemic implications for the functioning of banking systems and economic performance more generally.*
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> *Second, the view broadly associated with large US securities firms is that fair value accounting should be the standard for most financial instruments. This view is based on the belief that fair valuation is significantly more relevant than historical cost for financial instruments and is sufficiently reliable if appropriate policies, governance, controls and disclosure are in place. Further and importantly, fair value has been standard practice among US securities firms for many years, without adverse consequences,*

[28] Group of Thirty, *Enhancing Public Confidence in Financial Reporting*, p2-3. For a full discussion of these topics, see the Overview: http://www.group30.org/docs/G30=Overview.pdf.

and those firms believe that its use has encouraged a disciplined approach to risk management that, if more broadly applied, could engender greater market discipline and greater financial stability.

Third, the view of FASB that fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives. However, FASB (and IASB), as well as the community of regulators recognize that there are difficult issues associated with the application of fair value accounting, with an important issue being reliability, particularly with respect to instruments for which there is little or no direct price visibility."

In discussing the issues raised above surrounding fair value, the Group did not reach a consensus on the use of fair value, but recommended that dialogue should focus on the questions of: (1) the definition of fair value — whether it is simply measured as price times quantity or whether some adjustments should be made that would reflect concentrations or less liquid instruments; and (2) the scope of its application — to which financial instruments fair value should apply.

The debate essentially raises the question of accounting measurement. One option is to recognize either the business model in which the asset is held or management's intent regarding that asset. A second option is to simply reflect the attributes of each transaction and show subsequent re-measurements identically. Interestingly, outside the financial sector, consideration of business model and management intent is core to accounting measurement principles. In fact, management intent governs accounting for most of the costs held on the balance sheet.

It may be overly simplistic to believe that the objectivity achieved by measuring all assets and liabilities identically adds reliability to financial reporting. Although financial reporting purports to contribute to the measurement of business performance, doing so without regard to management's business objectives may result in: (1) denying shareholders management's view of performance; (2) either business practices being changed or complex, technical structures developed to achieve accounting results; or (3) distancing management from accounting matters because the accounting performance presented bears little resemblance to the underlying business or economic performance of the position.

One such example of circumstances where economic activity can be misrepresented by virtue of accounting rules is the case whereby derivatives,

which are marked to market, are hedging assets or liabilities measured at cost less impairment. Precise and extraordinarily complex rules govern when so-called hedge accounting can be applied. In the US, FAS 133 "Accounting for Derivative Instruments and Hedging Activities" came into effect in 2001. IAS 39 "Financial Instruments: Recognition and Measurement" was first issued in 1999, was subsequently revised and re-issued in 2003, and is currently being revised again to refine the availability of a "fair value option." These standards were developed not only in response to innovations in global financial markets, but also sought to address instances where companies were using derivative structures to engineer accounting results that did not reflect underlying economic activity.

FAS 133 requires all derivatives to be recognized as assets or liabilities on the balance sheet and to be measured at fair value. How changes in a derivative's fair value are accounted for depends on the intended use of the derivative — whether or not it is designated as a hedging exposure and what it is hedging. The issues in applying FAS 133 and IAS 39 have been enormous. Under both FAS 133 and IAS 39, firms must comply with highly prescriptive documentation requirements and must demonstrate a hedge's effectiveness. In addition, issues such as the practical difficulties in applying strict hedge accounting rules to economic hedging strategies have discouraged some firms from applying hedge accounting for transactions where they are economically well-matched. Thus, the complexity of financial instruments is creating a situation whereby firms may have no choice other than to follow an accounting standard's detailed requirements that yield an accounting result that may have little relevance to the economics of a transaction or an entity's risk profile.

Moreover, emerging governance requirements and regulatory changes such as Basel II are adding financial and risk disclosures which are not always consistent with GAAP disclosures. Not only does this make reconciling two sets of disclosures extremely complex for users, but it also makes it expensive for firms to make these disclosures. The goal of increased transparency and market discipline through greater understanding and comparability of firms' performance and risk profiles cannot be achieved without improved coordination between accounting practice, risk management practice and regulatory practice.