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Interpretations of regulatory reporting: A critical risk

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Interpretations of regulatory reporting: A critical risk

The increasing complexity of regulatory reporting requirements compels firms to frequently conduct thorough interpretative analysis to provide conformance with regulatory requirements. Fact patterns for products and transactions can vary widely requiring constant monitoring and awareness of changing reporting requirements. It is not possible for regulators to provide specific guidance for all the variations in reporting that can occur across firms. Therefore, firms are left with taking responsibility for deciding how to report when explicit guidance is absent.

Incorrect judgments about reporting requirements creates significant risk for materially misstating regulatory reports or being noncompliant with regulatory requirements. To mitigate this risk firms should develop a well-defined, effective regulatory reporting interpretation process.

What is regulatory reporting interpretation risk?

Interpretation risk occurs when a firm applies judgment to a data definition or regulatory requirement that is not explicitly covered by rules, regulations, or reporting instructions. Interpretation risk can occur at the data source, data attribute, or derivation level. The complexity of reporting makes interpretation risk high, especially for firms with intricate contracts and transactions. This risk is particularly acute in capital and liquidity reporting where some of the most granular and complex requirements exist.

Mitigating the regulatory reporting interpretation risk

A regulatory interpretation process will not guarantee that regulators will agree with all of the firm's conclusions. However, an effective process can evidence that sound analysis is conducted and the appropriate level of approvals are provided for, thereby demonstrating the proper level of due diligence and an effective control environment.

An effective regulatory reporting interpretation process has four pillars:

1. Analysis
2. Documentation
3. Governance
4. Escalation and communication

An emerging practice is establishing an interpretation group that is not directly part of the report preparations operations. This ensures independence. Of course, internal audit plays a role in assessing the effectiveness of the interpretation process.

Pillar 1: Analysis

The analysis stage starts by outlining the scope of the issue. This may take the form of a problem statement. For example:

What is the maturity of derivative contracts when optionality exists on Schedule L of the FRY 9C?

Once the problem statement is clearly defined, a description of the product or transaction in question is detailed. This includes the specific terms of the agreements and contracts.

With the scope and specific product description complete, all the authoritative literature (e.g., rules, regulations, reporting instructions) are identified and gathered. Other factors may also be considered, such as industry practice—although this is not a determining factor, but rather should be used in support of other facts and considerations. Institutions should also consider the purpose of the data collected, which can provide important context on the reporting requirements (information about the purpose of the data is included in the rulemaking that established the reporting requirement and report form). After analyzing the products or transactions in connection with the authoritative literature, alternatives for reporting solutions are identified.

The last step in the analysis stage is choosing which of the alternatives provides the best reporting solution for the specific fact pattern. Each alternative should be equally weighted and the reason for not adopting an alternative should be articulated to the same extent as the alternative that is chosen. Lastly, firms should validate that interpretations and conclusions are consistent with past interpretations.

Pillar 2: Documentation

The documentation of the analysis and conclusions are critical artifacts that evidence the depth of the interpretation process. Good documentation also serves to help solidify that the interpretation is correctly implemented throughout the firm. All aspects of the analysis and conclusions should be clearly detailed. Any “informal” discussion with regulators and industry groups, or considerations of industry practices, should be included. Differences from former interpretations should be described. A list of the preparers of the interpretations and approvers should be included as part of documentation, as well.

To arrange for interpretations to be available for ongoing use, interpretations should be inventoried and stored in a central repository.

Pillar 3: Governance

There are four parts to an effective regulatory reporting interpretation governance process: definitions, challenge and approval functions, ownership, and accountability.

As with any effective governance process, definitions are foundational to how and when to execute the governance process. Therefore, defining what is and is not an interpretation is critical, as well as involving the appropriate stakeholders such as accounting policy, legal, business, etc. One definition of an interpretation may be: *“Any judgment made by the firm in reporting a regulatory report where the product or transaction is not covered in a rule, regulation, standard, reporting instruction, or other artifact.”*

An interpretation can be attached to a reported value, regulatory requirement (e.g., regulatory capital calculation), or data attribute (e.g., counterparty classification, maturity date). An interpretation is not used to list disagreements with regulators or to document risk acceptance of nonconformance with regulatory requirements.

A challenge function should be established to independently review the interpretative findings and confirm the interpretations are well supported and analytically sound. Stakeholders comprising the challenge function should be from the first and second lines and include data and report owners. It’s critical stakeholders have a working knowledge of regulatory reporting and the firm’s products. As part of the final interpretation package, the discussion of the stakeholders’ review should be included.

Ownership of an interpretation goes beyond the approval process. The owner of an interpretation should be prepared to revise the interpretation as new information becomes available. For example, a change in the reporting instructions that conflicts with the interpretation. As with all aspects of regulatory reporting, accountability for adhering to the approved interpretations should be in place. At a minimum, accountability for following the interpretation process should be included in the broader accountability policy for regulatory reporting.

Pillar 4: Escalation and communication

Providing for the effective execution of a firm’s regulatory reporting interpretation process requires an escalation procedure where issues can be escalated to senior management, board committees, or regulators. The escalation procedures are often based on the impact, such as the dollar size or effect on regulatory requirements (e.g., capital calculations).

The communication process is just as important as the escalation process. Communication protocols are needed to inform all stakeholders, including regulators, of new or revised interpretations to allow stakeholders to provide the correct data, adjust processes, and make appropriate business decisions.

The need will continue to grow

The complexity of regulatory reporting requirements is likely to continue to increase as more granular data is requested and financial innovation evolves. The result will likely be the increasing need for firms to analyze and interpret regulatory requirements. An effective regulatory reporting interpretation process will be needed more than ever to avoid material misstatements of regulatory reports and meet regulatory expectations. Therefore, firms should take time to assess their current process for interpretation of regulatory requirements, identify gaps and risks, and take steps to close these gaps.



Regulatory Insights to action

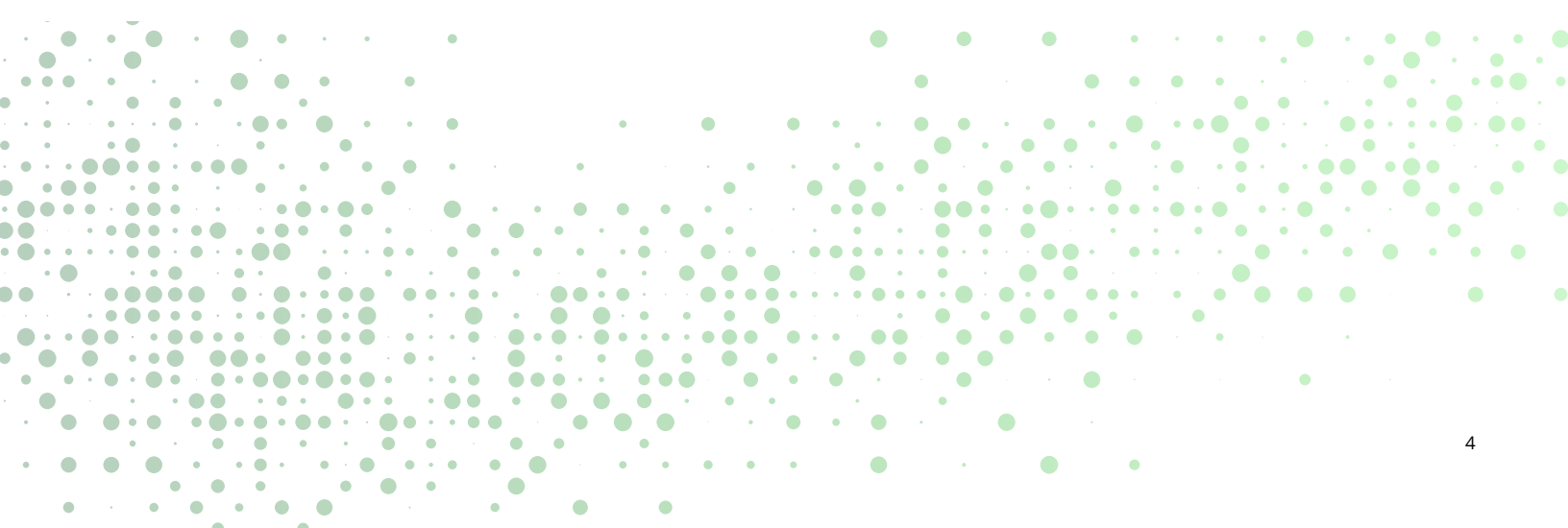
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Center for Regulatory Strategy US

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