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FINANCIAL SERVICES

Evolving Banking Regulation

A long journey ahead – the outlook for 2012
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About this report

This report was developed by KPMG's network of regulatory experts. The insights are based on discussion with our firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies.

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Foreword

Welcome to the latest edition of Evolving Banking Regulation. We are publishing this in a time fraught with uncertainty, with the European debt crisis in danger of creating a global wave of instability and dragging down global economic growth.

Jeremy Anderson
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This poses substantial challenges for banks, not least increasing credit risk, threatening the supply of funding and limiting opportunities for growth. In addition, there has been reduced bond and equity issuance, and subdued M&A activity.

In our previous two reports we focused on the "first wave" of regulatory reform in response to the financial crisis, with a particular emphasis on the tougher Basel 3 capital and liquidity standards, remuneration, central clearing of Over The Counter (OTC) derivatives, and the Dodd-Frank Act. This year we focus on two main areas – the implementation of various reforms across regions and countries, and the "second wave" of regulatory reform, which at the global level has concentrated primarily on systemic risk and on Systemically Important Banks (SIBs).

These banks will be subject to a range of measures to make them both safer and easier to wind-down in a crisis – capital surcharges, holding bail-in debt and recovery and resolution planning. The initial focus will be on the twenty-nine banks designated as being of global systemic importance ('G-SIBs'), with a clear intention to apply the same framework at the next stage to banks of national or regional systemic importance. Meanwhile, it is important not to lose sight of the continuing evolution of regulatory interventions in other areas, including the structure of wholesale markets, consumer protection and corporate governance.

In my discussions with senior bank executives they refer consistently to four major areas of concern:

- The amount of senior management time spent on dealing with the regulatory agenda.
- While the main impact of the first wave of regulatory reform was to increase the cost of conducting existing business, the second wave is forcing executives to consider fundamental changes in their business models and operating structures.
- Despite the long transition period set out for the implementation of Basel 3 capital requirements, banks are in reality being forced to make rapid adjustments, due to a combination of market and regulatory pressures.
- Even where there is global convergence of the regulatory agenda and of regulatory rulebooks, local supervisory judgements may generate uneven implementation. Internationally active banks worry that this could increase costs and reduce group-wide synergies.

Over the year ahead I expect these concerns and the unrelenting development and implementation of regulatory change to create a number of pressure points for banks and their regulators.

First, the aggregate impact of regulatory reform and the accelerated timetable for adjustment may be coming close to the tipping point at which the costs of regulatory reform – through the negative impact on the real economy from reduced availability of bank lending and other banking services – begin to exceed the benefits to financial stability.[1]

Second, banks will need to focus on services which generate most value and adjust their strategies and business models accordingly – this may result in moves towards simpler banking models and further shifts in business to the developing markets, to benefit from high growth rates.

Third, although both banks and their supervisors have much to gain from greater cross-border cooperation among supervisors and resolution authorities, this will be difficult to achieve in practice – not least at the point at which a large cross-border bank fails. The price of not making progress on cross-border resolution will be tougher ring-fencing by national authorities.

I hope that this publication will encourage and inform discussion on regulatory reform in the global context and how this will influence banks' strategies and business models. As ever, the process of change will generate both opportunities and threats, and early and well-considered responses will reap the greatest rewards.

1. Refer to section 'The Cost of Reform and its Impact on Growth'.

Executive Summary

The banking sector continues to be re-shaped by the ever-expanding set of regulatory and related reform initiatives at global, regional and national levels. Each of these initiatives plays its part in enhancing financial stability, protecting investors and consumers, and making it easier to deal with failing banks. But they could also have significant negative impacts on banks and their business models, and in turn on banks' customers and the real economy. A long and difficult road lies ahead.

Key Policies Driving Reform

There are a number of key drivers, common across the three regions, that will influence the strategy, business models, size, shape, structure and cost to banks over the next few years:

1 Systemic Risk, Recovery and Resolution Planning – added capital and supervisory dimensions for systemically important banks and regulatory pressures for new business models
2 Capital and Funding Strategy – increased capital funding costs and slimmer balance sheets
3 Supervision and Reporting – more intense supervision and ever-expanding reporting requirements
4 Governance and Remuneration – governance and remuneration enhanced accountability and risk-related metrics are key
5 The Customer Agenda – more checks and balances to protect customers and combat mis-selling

Major Implications of Regulatory Reform

There are many issues stemming from the contagious debt crisis and the avalanche of regulatory reform but two implications, in particular, are most critical:

1. Structural Reform and New Business Models – The process of undertaking complex business and structural reviews and adjusting to new ways of doing business consumes significant time and money. Banks are under severe pressure to determine the strategies and businesses that will maximise their value in response to the woeful economic climate and long list of regulatory demands.

2. Costs of Reform and Impact on Growth – Historic bank returns look unlikely to return, not inspiring investors. Coupled with downgrades for some of the largest banks and the pressure to cover the cost of capital it is appropriate to consider whether we are at the point at which the costs of reform exceed the benefits and are contributing to unnecessarily slow economic growth.

Banks are under severe pressure to determine the strategies and businesses that will maximise their value in response to the woeful economic climate and long list of regulatory demands

Global regulatory pressure

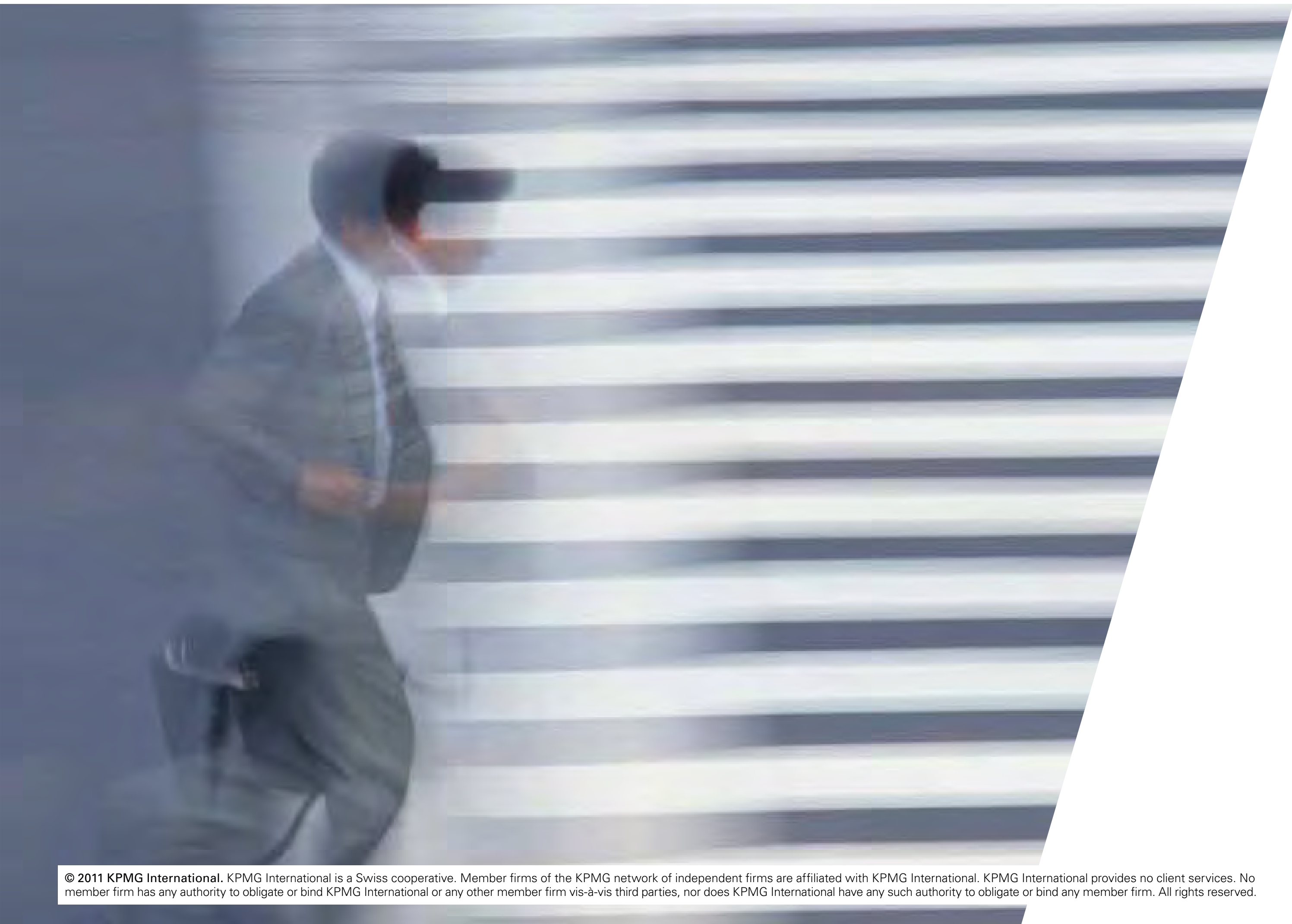
The Regulatory Pressure Index sets out an assessment of the scale of the challenge posed by key areas of regulatory reform across Europe, the US and ASPAC, and considers the impact on business models and the cost and complexity of reform. Similar to findings last year, the greatest regulatory challenges face banks in the US and Europe, although the Basel 3 liquidity rules are proving to be as painful for banks in ASPAC as for those in other regions.

Regional perspectives

The three regional perspectives discuss the progress of key regulatory reforms in these regions over the past twelve months and the most pressing issues for banks. In Europe, we consider the challenges of capital and liquidity issues, structural and market reforms, supervision, governance and remuneration, consumer protection issues and the Financial Transaction Tax (FTT). In the US, we analyse the progress of implementation of the Dodd-Frank rules, the key areas to be finalised and expectations for 2012. In ASPAC, we look at the impact of Basel 3, RRPs, restructuring, corporate governance and some of the key national developments in the region's largest financial centers.

Regulatory Pressure Index

The regulatory pressure index sets out an assessment of the scale of the challenge posed by key areas of financial sector reform for three major regions – Europe, the United States and the Asia Pacific region. This is based on discussions with clients in each of these regions, as well as on KPMG's assessments of key regulations and discussion papers. The table includes an assessment for 2010 so that comparisons can be made on how pressures have changed.



Regulatory Pressure Index

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Capital **Objectives:** • Increase both the quantity and quality of capital buffers in order to reduce the possibility of a repeated banking crisis **Policies:** • Basel 3 (Global) • CRD 4 (Europe) • Dodd-Frank (US) • Capital Surcharges (FSB) • Structural Change (UK)	2010 **2011**	4 **5**	4 **4**	2 **3**	• Basel 3 requirements are impacting on all banks globally, with many in the West struggling to raise capital in a time of deep uncertainty. • In Europe, reforms are really starting to bite and the European Banking Authority (EBA) has set a bar of 9 percent of core tier one capital to Risk-Weighted Assets (RWA), for banks stress-tested in 2011. This is higher than that required under Basel 3. • In Asia, regulators are also setting local requirements well above the new Basel minimum. • US banks raised US $200-300 billion in new capital in 2009, so they appear to be better capitalised, on a comparative basis, than their European counterparts.
Reform: Liquidity **Objectives:** • Ensure that banks have enough liquid assets to meet a potential run on funds **Policies:** • Basel 3 (Global) • CRD 4 (Europe)	2010 **2011**	5 **5**	4 **4**	4 **5**	• Banks need to focus strongly on liquidity. The Liquidity Coverage Ratio (LCR) will bring structural changes to the short-term debt markets. In Europe, banks will struggle to meet the 100 percent coverage required. • In the US, compliance with Basel 3 may be challenging but funding is not currently a problem for most big US banks. • In Asia, many regulators are considering applying the ratio on a sub-consolidated (country) basis, which brings additional complications, in particular for the treatment of intra-group funding. Many banks, as a consequence, must look closely at how they fund their overseas operations.
Reform: Systemic Risk **Objectives:** • Reduce the domino effect on the industry when a large institution fails **Policies:** • Capital Surcharges (FSB) • Dodd-Frank (US) • Crisis Management Proposals (EU) • Structural Change (UK)	2010 **2011**	5 **5**	5 **5**	1 **2**	• Large global banks have to meet increased capital requirements, prepare RRPs and are subject to enhanced supervision. • In Europe, Crisis Management proposals will force European banks down the same route. • In the US and the UK, banks have already begun to draw up recovery plans with the authorities responsible for drawing up resolution plans, based on information provided by the banks. • In Asia, banks in some of the major centres (Australia, Japan) are also being required to prepare RRPs.
Reform: Supervision **Objectives:** • Ensure that the industry is properly and fairly regulated **Policies:** • New supervisory structures, eg. in the US, UK, and Europe • More intrusive supervision • Dodd-Frank (US)	2010 **2011**	4 **5**	5 **5**	2 **3**	• There is a notable increase in the amount and depth of supervision across the three regions. • In Europe, new supervisory structures are beginning to assume authority and supervision is more intrusive and intense than before. • In the US, similar to Europe, new authorities are assuming control and existing ones continue to intensify their assets • In Asia, there is less focus on changing the structure of regulatory authorities, but a more intense style of supervision.

Key: **5** = significant pressure **3** = moderate pressure **1** = low pressure

Regulatory Pressure Index *continued*

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Governance **Objectives:** • Ensure that Boards have sufficient skills experience and availability to assume full accountability for the decisions taken by the organisation **Policies:** • Dodd-Frank (US) • CRD 4 (Europe) • MiFID 2 (Europe) • EBA Governance Guidelines (Europe)	2010 **2011**	4 **4**	4 **4**	4 **4**	• Global, regional and national policy bodies have outlined principles and guidelines for good governance, but the biggest challenges will come from higher expectations of board accountability and its effective operation. • Banks in Europe have started to implement new governance structures in preparation for new guidelines, included in CRD 4 (Capital Requirements Directive 4), MiFID and others that are expected to be finalised in 2012 and implemented in 2014. • In the US, the Dodd-Frank Act (DFA) requires many firms to have a risk committee and will likely result in new compliance programs. • Several regulators in Asia (China, Singapore and Malaysia) have also put a focus on improving banks' governance.
Reform: Remuneration **Objectives:** • Regulate excessive remuneration practices **Policies:** • FSB principles on remuneration (Global) • Dodd-Frank (US) • Walker report (UK)	2010 **2011**	4 **3**	3 **3**	1 **1**	• Bonus payments, rather than fixed salaries, continue to make up the bulk of senior bankers' pay at some of the world's biggest banks, particularly in the US and the UK. • European bank regulators are once again considering whether banks should use a fixed ratio for payment of bonuses versus salaries. • In the US, the Federal Reserve's horizontal review of compensation programs at large complex banking organizations found improvements in certain compensation practices, but concluded that additional efforts are needed to properly align incentives with risk taking and reward. • In Asia, bonus pay accounts for only 30 – 60 percent of the total pay awarded to senior executives, with a lower percentage again in Japan.
Reform: Customer Treatment **Objectives:** • Protect the customer, help the customer make informed investment decisions and ensure that the products sold to the customers suit his/her investment profile **Policies:** • MiFID (Europe) • Dodd-Frank (US) • CASS Directive (Europe) • RDR (UK) • PRIPs (Europe)	2010 **2011**	3 **4**	4 **4**	1 **2**	• In Europe, a flood of rules, including the review of the Markets in Financial Instruments Directive (MiFID 2), Packaged Retail Investment Products (PRIPs), and Retail Distribution Review (RDR) are evolving to protect the customer. • In the US, there is a consumer protection and mortgage reform agenda under Dodd-Frank that also created the Consumer Financial Protection Bureau (CFPB) and others. Additional rules will continue to come into force as new issues emerge. • In Asia (particularly Hong Kong and Singapore), the focus remains on retail investment products. Australia continues to push ahead with its own rigorous conduct regimes.

Key: **5** = significant pressure **3** = moderate pressure **1** = low pressure

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Traded Markets **Objectives:** • Help reduce risk in the wholesale markets and regulate the Over the Counter (OTC) derivatives market **Policies:** • Dodd-Frank (US) • MiFID (Europe) • EMIR (Europe)	2010 **2011**	4 **4**	4 **4**	1 **2**	• There has been a lot of activity in traded markets regulations, even if slower and less globally consistent than was promised. • The Dodd-Frank Act in the US, EMIR and aspects of MiFID 2 in Europe all impact the structure of wholesale markets and in particular how derivatives are cleared, settled and reported. • Key ASPAC markets are beginning to formulate policies in response to the G20 agenda on derivatives. • Beyond the G20 agenda, some nations continue to push ahead with structural separation of trading activity. The Volcker rule in the US is under consultation and in the UK proposals from the Independent Commission on Banking (ICB) to ring-fence retail deposit taking has prompted similar analysis in other European countries.
Reform: Accounting and Disclosure **Objectives:** • Consider whether accounting policies need to be revised and the additional disclosures that may be required **Policies:** • IFRS 9 • COREP	2010 **2011**	3 **3**	3 **3**	3 **3**	• There are changes to the valuation, recognition and impairment rules. This will change the way banks are analysed and the way in which financial instruments are accounted for and reported. In particular there is a requirement to consider: – Critical accounting judgements and key sources of estimation uncertainty – Inputs to valuation models – Timing and value of impairments – Pending agreement on a new 'expected loss' approach to impairment, a number of regulators in Asia (China, Hong Kong, Taiwan) are pushing banks to raise their regulatory provisioning.
Reform: Tax/Compliance Burden **Objectives:** • Ensure that investors comply with the relevant tax authorities • Use tax as a means of paying for some of the costs of the crisis **Policies:** • FATCA (US) • FTT (European/Global)	2010 **2011**	n/a **4**	n/a **4**	n/a **3**	• Foreign Account Tax Compliance Act (FATCA) introduces a new withholding tax regime and will place a significant burden on many global financial services firms affecting operations, IT, front office and number of areas of their business. • Proposals by the European Commission for a Financial Transaction Tax (FTT) will impact on compliance and if passed, will be a significant challenge and costly exercise for banking institutions.

Major Implications of Regulatory Reform

01
Structural Reform and New Business Models

Banks face a pressing need to reassess the viability of their current strategies and business models in response to a myriad of regulatory pressures, and to other factors such as macro-economic developments in the countries in which they operate.

Some of the regulatory and related reform initiatives – capital, liquidity, recovery plans, bail-in debt, consumer protection, reporting, taxes and levies – will have an unprecedented impact on the costs of banking activities. Overall, these costs will be huge and will force many banks to scale back some of their business, while seeking opportunities to maintain or expand other activities through aggressive cost-reduction, deleveraging and restructuring. Other initiatives – resolution planning, constraints on how derivatives are structured, traded and cleared, the Volcker rule in the US, and the retail bank "ring-fencing" recommendations of the Independent Commission on Banking (ICB) in the UK – will result in direct interventions in the activities that banks can undertake, in how they can undertake them, and in banks' legal entity and operational structures.

The cost and complexity of dealing with regulatory change will be magnified by the potential tax costs of any restructuring. In addition, and largely outside the control of either regulators or banks, investors in bank capital, providers of wholesale funding, retail depositors, and corporate and retail borrowers will all be deciding themselves about the terms by which they are prepared to invest in, lend to, or borrow from, banks – which will add to the pressures on banks and force banks to adjust further.

As a result, banks are already implementing or considering various changes to their strategies and business models, including:

- Becoming smaller and safer, with lower but less volatile profits
- Defining a narrower set of core activities, becoming more specialised, and exiting from non-core activities
- Moving away from universal and full service banking
- Adopting a 'utilities' model of focusing narrowly on the traditional core banking activities of deposit taking, retail and corporate lending, and payment system services
- Increasing market share in chosen core activities, through consolidation, mergers and acquisitions, to boost margins from economies of scale and market power
- Retrenchment from international and cross-border activities
- Geographic focus on a small number of high growth markets.

As part of the requirement to enhance capital, some banks will consider the use of "bail-in" debt. Bail-in debt automatically converts to common equity when a bank's capital levels dip below a prescribed amount or when a bank becomes "non-viable". The tax authorities will need to decide whether to treat this debt as true debt for tax purposes or as equity.

Overall, these costs will be huge and will force many banks to scale back some of their business, while seeking opportunities to maintain or expand other activities through aggressive cost-reduction, deleveraging and restructuring

Where is the 'tipping point' at which the costs of these reforms begin to exceed the benefits?

02 The Cost of Reform and its Impact on Growth

The most important 'known unknown' facing regulatory authorities is the cumulative impact of the multitude of regulatory and related reform initiatives that have been launched over the last four years. All of these initiatives are designed to make the financial system safer, to improve investor and consumer protection, or to make it easier to deal with the failure of financial institutions. But they also impose costs on, and change the behaviour of, financial institutions, with consequences in turn for their customers and ultimately for the real economy. Where is the 'tipping point' at which the costs of these reforms begin to exceed the benefits?

For most of 2011, the FSB/BCBS and the Institute of International Finance (IIF) have been trading blows on the macro-economic impact of regulatory reform.

In October 2011 the FSB/BCBS published their latest estimates of the impact, extending this to cover the BCBS proposals on a capital surcharge for G-SIBs. The key element of their approach is that for a one percentage point increase in banks' capital ratios, lending spreads increase by 16 basis points and real GDP falls over eight years to 0.17 percent below its baseline level before rising back to baseline. The impact would be greater if implementation were more rapid – for example, real GDP would fall 0.19 percent below baseline if reforms were implemented over four years.

At the end of 2009 banks' average core tier one ratios were 5.7 percent, compared with the Basel 3 minimum of 7 percent. Therefore, the cost of moving up to 7 percent over the Basel 3 transition period would be a 0.23 percent fall in real GDP (1.3 x 0.17 percent). In addition, since G-SIBs represent around one-third of bank lending, each one percentage point additional increase in their capital ratios above 7 percent would reduce real GDP by 0.06 percent (ie. one-third of 0.17 percent). Assuming an average two percentage point increase in ratios for G-SIBs, this would lower real GDP by an additional 0.12 percent, giving a total decline of 0.34 percent. Lending spreads are estimated to increase by a total of around thirty basis points under this scenario.

These estimates do not include any impact from higher liquidity ratios. A 25 percent increase in liquid assets is estimated by the FSB/BCBS to reduce real GDP by 0.13 percent. However, since this would also reduce banks' risk-weighted assets, there would be some offset as capital ratios would improve.

The IIF published updated estimates in September 2011 which reduced the IIF's earlier estimates of the impact of Basel 3 but added the impact of the G-SIB capital surcharges. The overall estimated cost is ten times larger than the FSB/BCBS estimates, with real GDP 3.2 percent lower in five-years' time and lending spreads estimated to rise by 364 basis points.

Any estimates have to take a view on what will happen to the cost of banks' capital and long-term funding (the FSB/BCBS view that this should not increase in the long term and will not increase significantly even in the short term, while the IIF assumes a much sharper increase in capital and funding costs, especially over the next five years); the extent to which higher costs of capital and funding are passed on to borrowers through higher lending spreads; the extent to which banks improve their capital ratios by raising additional capital rather than by contracting their risk weighted assets; and on the transmission mechanism from higher lending spreads (and/or from deleveraging) to real GDP. Moreover, the IIF estimates focus almost exclusively on the capital element of regulatory reform, and do not capture the impact of the long list of other reform measures.

While this academic debate has been raging, the true answer has become increasingly evident in the real world, where increases in capital ratios and attempts by banks to improve their liquidity positions have occurred much more rapidly than under the eight-year path set out under Basel 3. This has been the result of a variety of market and regulatory pressures, seen most recently in the form of the European Banking Authority's '9 percent' stress test and the latest Federal Reserve Bank stress tests in the US. This massively shortened adjustment period has significantly increased the costs of banks' capital and long-term funding, pushed up lending spreads and made banks more reluctant to extend fresh credit to borrowers. It has led to a reliance by banks on reducing leverage rather than raising new capital or retaining earnings and had a marked negative impact in real economic growth.

There may, however, be some important differences across countries here – with nasty downward spirals in countries where rapid adjustment by banks has worsened the economic condition and outlook, and rather less impact where banks have not adjusted yet (or not had to adjust).

Key Policies Driving Reform

01
Systemic Risk, Recovery and Resolution Planning

Systemic Risk

Although dominated by the Eurozone problems, the G20 summit in October 2011 demonstrated the determination of the authorities to press ahead with a second wave of major regulatory reforms, building on the tougher capital and liquidity standards already agreed in the Basel 3 package. The G20 agreed on a package of measures for global SIFIs (G-SIFIs), including capital surcharges on global systemically important banks (G-SIBs); a requirement for G-SIFIs to have credible recovery plans and for the authorities to be able to develop effective resolution plans for these institutions; and more effective supervision of SIFIs. The G20 also reiterated its view that similar requirements should apply to banks that are of systemic importance at a national or regional level, even if not of global importance.

The Financial Stability Board (FSB) published an initial list of twenty-nine banks currently considered to be of global systemic importance. This includes seventeen European banks, eight from the US, three from Japan and one from China. Some very large but primarily domestic banks were included on this list, including Banque Populaire, Dexia, Lloyds Banking Group and Wells Fargo, while some major international banking groups – such as BBVA and Standard Chartered - were excluded. G-SIBs will be required to hold a capital surcharge of between 1 and 2.5 percentage points on their core tier one capital ratios, with an additional one percentage point surcharge held in reserve in case a global bank becomes even more systemically important.

Recovery and Resolution Planning

The FSB's principles for recovery and resolution planning (Appendix Table 4) aim to introduce a common set of powers and tools that all national authorities should put in place to enable the smooth resolution of a SIFI without costs to the taxpayer, including the power to 'bail in' debt as part of a resolution. In addition, SIFIs should be required to construct credible recovery plans that would enable them to recover from a range of severe stresses, and to provide information to the authorities from which the authorities could construct an effective resolution plan. The FSB acknowledged that limited progress has been made on harmonised resolution regimes for major cross-border groups.

Although very uneven at present, these principles are beginning to be implemented. At the EU level they are expected to underpin a new Crisis Management Directive that will apply to all credit institutions, not just to SIBs. In the US, the authorities have finalised rules on the information that large banks will have to provide on resolution planning. And the authorities in many other countries – including Canada, Australia, Japan, the Netherlands, Spain and the UK - have begun to discuss recovery and resolution planning with their major banks.

RRPs and Crisis Management proposals help drive the need for structural change. Although the UK is leading the way, there appears to be convergence of the global regulatory agendas in this area. The EC recently announced that it will commission an analysis of the implications of possible structural change on European banks next year.

RRPs and Crisis Management proposals help drive the need for structural change, and although the UK is leading the way, there appears to be convergence of the global regulatory agendas in this area

Banks will face high costs in making changes to their business activities and to their legal entities and operational structures in order to satisfy the authorities that a credible resolution plan can be constructed. These include:

- Developing and implementing contingency plans
- Reporting recovery plans and resolution packs to the authorities
- Creating a comprehensive, regularly updated and ring-fenced management information system to support resolution planning
- Limiting intra-group exposures
- Establishing service level agreements that are legally enforceable in crises and in resolution.

Banks will need to remain responsive to details that remain to be determined, including recovery and resolution planning requirements that national authorities will

02
Capital and Funding Strategy

impose on banks that are of national importance, even if they are not classified as G-SIBs, or even on all banks. Also to be determined are the amounts and types of 'bail-in' debt that banks are required to hold and the different approaches that national authorities may take on bank activities regarded as being critical. In addition, there is the extent to which banks will be required to change their business activities and their legal and operational structures in advance to reduce the potential cost and complexity of resolution and the point at which the authorities will trigger a resolution.

The implications for SIBs are significant. For many banks, this second wave of regulatory reforms will represent a tipping point. They will need to seriously consider the impact of these proposals on their strategies and business models. Significant changes may be required to preserve business value. The potential 'bailing-in' of a wide range of unsecured and uninsured creditors will also have major implications for the cost and availability of funding, and will encourage creditors to fund SIFIs on a secured rather than unsecured basis.

The implications for SIBs are significant. Banks will need to seriously consider the impact of these proposals on their strategies and business models

The tougher Basel 3 capital and liquidity standards (Appendix Table 1) are being rolled out globally, albeit not in an entirely consistent manner. The effective implementation date of these standards is being accelerated through various market and regulatory pressures, including the application of demanding stress tests by regulators.

In the EU, the Basel 3 text has largely been copied into the latest Capital Requirements Directive (CRD 4), (Appendix Table 3). The intention is to implement CRD 4 across the EU in the form of a maximum harmonising regulation, which would constrain the discretion of national authorities to impose anything other than the requirements set out in CRD 4. More immediately, a number of European countries and the EBA have imposed tough stress tests based on higher capital ratios than in Basel 3 – the latest EBA stress test requires major EU banks to meet a 9 percent core tier one capital ratio by June 2012. We wait to see liquidity in detail.

In the US, the regulators have not yet proposed new capital rules but have announced an intention to follow the Basel 3 principles. One constraint here will be the Dodd-Frank Act restriction on using credit rating agency ratings in regulations. Meanwhile, many banks have been undertaking comprehensive firm-wide Basel 3 assessment exercises to understand their capital and liquidity requirements and to begin to plan for changes to ensure compliance with the Basel 3 deadlines. US regulators have been applying a series of stress tests since 2009 focusing on the quality and quantity of capital and have pushed many banks to raise significant amounts of capital. In many cases, banks' current capital levels exceed the Basel 3 requirements. In Asia, countries have taken different approaches to the implementation of Basel 3, with many countries imposing higher minimum capital ratios than those in Basel 3 and accelerating the implementation timeline.

Although some policymakers argue that raising capital should become cheaper as banks become safer, the sheer volume of capital required to meet the new standards is likely to push up costs, especially in the short term. Banks are therefore improving their capital ratios through a range of adjustments, including not only new capital issuance but also higher retention of earnings (in particular through lower dividend payments), cost reductions, reducing on-and off-balance sheet exposures, buying insurance cover on the first tranche of potential losses and selling non-core businesses. Concern over the impact of deleveraging on economic growth is already leading some regulators to put more pressure on banks to increase their capital through retained earnings generated by lower dividend and bonus payments.

Moving towards meeting the new liquidity standards is also a major and expensive challenge for banks. High quality liquid assets tend to carry very low yields, so holding them reduces profitability; it is difficult for banks in aggregate to increase retail deposits, so competition for retail deposits is increasing their cost. Similarly, the demand for longer-term wholesale funding is pushing up its cost to the banks. Banks may also therefore cut back on lending – with more than one-year maturity – that requires stable funding. A further unintended consequence may be the problems the new liquidity requirements cause for foreign banks funded either from their home markets or by means of wholesale funding. For example, many foreign banks play a major role in banking systems in Asia Pacific, but lack a local deposit base. If the new liquidity rules reduce these banks' ability to lend, they could have a negative effect on local economies.

The European sovereign debt crisis has highlighted that the value placed by Basel 3 on sovereign debt for both capital and liquidity purposes must be reassessed. Banks may choose to hold additional capital against sovereign debt even if it is zero weighted under Basel 3, but they may have less scope to diversify their liquid assets unless the regulatory requirements are adjusted.

The European sovereign debt crisis has highlighted that the value placed by Basel 3 on sovereign debt for both capital and liquidity purposes must be re-assessed

03 Supervision and Reporting

Banks in many countries are facing pressures from changes in supervisory structures and from heavily increased reporting burdens.

In the EU, three new European Supervisory Authorities (ESAs) have been established in a move to further integrate financial services supervision on a pan-European level. In the US, new agencies such as the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB) have been established alongside existing agencies. Many other countries are also changing their supervisory structures and introducing new bodies to undertake financial stability and macro-prudential oversight. In addition, an increased emphasis on cross-border regulation and supervision re-emphasises the need for effective supervisory colleges. Banks need to support and be linked in to these structures to ensure that they operate effectively.

Furthermore, the reporting burden on banks is increasing as a result of the implementation of Basel 3; the information requirements to assess the systemic importance of banks and underpin recovery and resolution planning; the increased emphasis on detailed stress testing; the reporting necessary to impose various new taxes and levies; the imposition of regional and national regulatory reform initiatives such as the reporting required in the US under the Dodd-Frank Act and the newly created Office of Financial Research (OFR), and the trade reporting and regulatory reporting required under the MiFID2 and European Markets Infrastructure Regulation (EMIR) legislation in the EU.

An increased emphasis on cross-border regulation and supervision re-emphasises the need for effective supervisory colleges. Banks need to support and be linked in to these structures to ensure that they operate effectively

Banks will need to enhance the quality of their data, systems and processes in order to meet these regulatory reporting requirements. Many of the new regulatory measures – for example in relation to market risk and liquidity risk – are stressed measures, which bank systems may not generally be well-suited to produce on a timely basis with sufficient flexibility to allow new scenarios and stress tests to be introduced. Together with bolstering systems and processes and considering the creation of data repositories where necessary, banks continue to lobby regulators to introduce greater consistency in data provision. Requiring banks to provide essentially the same data, adjusted for local preferences, to various regulators across a range of jurisdictions, will become an unwieldy and expensive process.

04 Governance and Remuneration

Governance is high on the agenda across the three regions. Supervisors are focused on increasing the accountability of Boards and the robustness of reporting and control frameworks. However, other than at the EU level and the high-level principles established by international standard-setters such as the Basel Committee on Banking Supervision (BCBS), it seems unlikely that detailed international standards will be introduced. This may be an advantage to the extent that governance structures differ widely across countries and regions and a single approach may not work well in all countries. Equally, banks with subsidiaries in many countries may find themselves subject to increasingly onerous and inconsistent requirements.

On remuneration, the application of the FSB principles on the structure of remuneration has not required banks to reduce bonus payments as a proportion of total pay. Nevertheless, many banks have significantly reduced the variable component of pay and increased the fixed aspect of compensation in some areas of their business. However, a recent report by the FSB reveals that bonuses still account for the majority of total pay awarded to US and UK banks' highest-paid employees. This is in contrast to Asia where bonus pay accounts for between 30 and 60 percent of the total pay awarded to senior executives with a lower percentage again in Japan. There have been discussions in the EU on setting a maximum ratio for the variable component of total pay, on the basis that this could reduce incentives to take excessive risk.

05 The Customer Agenda

Although much of the recent regulatory focus has been on prudential issues, there is also increasing emphasis being placed on consumer protection. The G20 has endorsed an FSB report on consumer finance protection and the development of consumer protection principles by the Organisation for Economic Cooperation and Development (OECD) and is committed to the full application of these principles in the G20 countries. Consumer finance is a key focus of consumer protection in the US, while in the EU a host of regulatory initiatives relate to how banks treat their customers. In Asia, new requirements have been introduced with regard to the selling of retail investment products in Hong Kong and Singapore, but there is not currently a strong impetus to significantly raise the customer agenda. A focus for banks will be designing strategies to develop, market, distribute and administer retail financial services products in a sustainable way whilst controlling conduct risk. There is a considerable amount of effort in improving investor information but the risk is that there is a point at which more information becomes too much information.

For banks, the data, systems and process implications of these regulations are substantial and onerous, but this is also an opportunity for banks to gain valuable commercial insight that could lead to the improvement of the customer experience and increased revenue. Banks globally are fighting to retain and attract customers – with a focus on how to optimise, rather than reduce, associated costs and how to improve the overall sales and service experience.

A focus for banks will be designing strategies to develop, market, distribute and administer retail financial services products in a sustainable way, whilst controlling conduct risk

Regional Perspectives: Europe, Middle East and Africa (EMA)

In Europe, the year 2011 started with policy makers clearly focussed on pushing forward with the G20 agenda for regulatory reform, and as we describe below, much progress has been made. However, the growing sovereign debt crisis and the scale of regulatory proposals have taken their toll.

The policies which will form the basis of implementing the G20 agenda in Europe have been issued in draft, and some, in final form. Restrictions on the structure of remuneration have been introduced in many countries across Europe. The Basel 3 package of tougher capital and liquidity standards has been translated into CRD 4; seventeen of the twenty-nine G-SIBs identified by the FSB are European; the FSB's high-level principles on recovery and resolution were mirrored in the European Commission's consultations on Crisis Management; moves to standardise OTC derivatives and to clear derivatives through central counterparties will be given effect through a combination of the European Markets Infrastructure Reform (EMIR) and the review of the Markets in Financial Instruments Directive (MiFID).

The European Union has been pressing ahead in other areas too. It is widening and strengthening consumer and investor protection through a number of initiatives, including the retail and wholesale market measures in proposed revisions to MiFID (MiFID2), and its consultation on packaged retail investment products (PRIPs), and it is introducing tougher requirements on corporate governance.

But then the sovereign debt issue crystallized…

The escalation in the sovereign debt crises in the second half of the year has diverted attention away from this broader agenda. The result has been delays and the development of additional regulatory proposals which are more of a response to the crisis than the G20. Final European Commission versions of EMIR and Crisis Management, first expected in the summer and then the autumn of 2011, have yet to arrive. Tough new rules for short selling, including bans on shorting sovereign credit default swaps, new rules for credit ratings agencies (which at one stage proposed suspending ratings on sovereigns) and a possible Financial Transaction Tax (FTT) to replenish European treasuries appear linked more to the sovereign than financial crisis and will add additional costs and constraints for banks, if passed.

Stress Tests

The sovereign debt crises have forced banks in Europe and beyond to write down the values of some of the government debt they hold on their balance sheets, or to take a loss as a result of forced sales or buy expensive credit insurance to reduce exposure. A second round of stress tests run by the EBA in the spring – with no stress applied to sovereign exposures – showed most banks well capitalised.

But the escalating crisis forced a new round of stress tests. The results, with sovereign exposures factored in, pushed the EBA to set a 9 percent core tier 1 capital ratio requirement on the seventy banks subject to the test, along with an additional buffer against sovereign exposures. The EBA estimates this will mean another EUR 115 billion of capital, but some analysts estimate the total to be much higher. Clearing this hurdle by raising capital or by selling assets poses significant challenges in the current risk averse and volatile markets. But this same environment is likely to limit earnings to retain, and deleveraging by reducing lending to the 'real' economy will be politically unpalatable. In practice, banks are likely to employ a combination of these measures, but achieving the target by June 2012 still looks like a stretch.

More generally, the sovereign debt crises in Europe have highlighted a clear fault line in Basel 3 and CRD 4, which treat the government debt of many countries as being risk-free for capital adequacy purposes and as being high-quality liquid assets for liquidity purposes. In addition, the new EBA capital hurdle of 9 percent diverges from the Basel 3 requirement of 7 percent, which European legislators have said should be a 'maximum' rather than a minimum.

Central Europe catches Western Europe's cold…

The spill-over now threatens to engulf central and eastern Europe (CEE) as western banks scale back lending, and the full exposure of eastern financial institutions and investors becomes clear. The financial sector in the CEE is

Tough new rules for short selling, new rules for credit ratings agencies and a possible financial transaction tax to replenish European treasuries appear linked more to the sovereign than financial crisis

dominated by subsidiaries of foreign multi-national banks (mostly European) and they are re-focusing resources on traditional core businesses and territories. In Hungary and Poland, regulators are keen to stem the tide of foreign currency mortgages. Mortgages in Swiss francs, for example, have risen steeply with knock-on effects for the local economy. This is most significant in Hungary where about two-thirds of mortgages are denominated in foreign currencies. Some foreign banks have reigned in their lending; others have closed subsidiaries or branches or announced their intention to do so.

The Way Forward…

Banks in Europe now face significant increases in costs to meet regulatory reforms. At the same time, earnings are being hit hard by write-downs of government debt. Some banks have to restrict their operational and legal entity structures in order to make them more easily 'resolvable', and face constraints on how they can undertake their business activities in some markets. As elsewhere, banks in Europe are responding by a combination of raising additional capital and liquidity, reducing the size of their lending and trading activities, and assessing their operational and legal entity structures. But they will need to go further than this in determining the changes required to their strategies and business models in response to regulatory reform and other developments, and in making the detailed operational changes required by the myriad of new regulatory requirements.

Capital and liquidity

The European Union intends to implement the Basel 3 package of capital and liquidity strengthening measures through CRD 4 (Appendix Table 3), which is due to take legal effect in 2013. Although CRD 4 is mostly a copy of Basel 3, there are some critical differences and additions. Of greatest interest for national supervisors (and the banks they supervise) are the proposals to set a

maximum harmonisation regulation. This move would mean that member states cannot impose higher (or lower) capital and liquidity ratios on their banks. The Commission has stressed that there is flexibility for national supervisors through 'pillar 2' requirements (though these are levied on individual banks rather than the system as a whole), through national use of the counter-cyclical capital buffer, and in due course additional requirements for capital surcharges on global and national SIBs, which will be set by the EU in response to the FSB framework for systemic banks. Some European countries have objected to this approach and are seeking greater discretion to impose higher capital and liquidity requirements on all their banks.

One response by banks to rising capital requirements is to improve risk assessments and also optimise risk weightings by improving models. In Germany, for example, most institutions that have already been audited by the German regulator (German: Bundesanstalt für Finanzdienstleistungs-aufsicht or BaFin) need to update their Internal Capital Adequacy Assessment Process (ICAAP) calculations and work closely with auditors who are responsible for assessing the regulatory compliance of systems and models used in the year-end audit.

The stricter approach to the definition of capital in Basel 3 and CRD 4, including the deduction of some items that national regulators have allowed to be included until now, will have a significant impact on some types of bank in Europe. For example, some German banks rely heavily on silent participations (commonly issued state-backed debt instruments with some equity characteristics) which are currently included as tier one capital in Germany, but would not count as tier one capital under Basel 3. The state-owned Landesbanken are currently in discussions with shareholders about shifting silent participations into higher quality capital. Banks in Germany that can access the capital markets may find it relatively straightforward to raise the necessary capital to fill the funding gap, but for many smaller institutions this will be more difficult.

CRD 4 also sets out reporting requirements for the new Basel 3 liquidity ratios during the 'observation periods' ahead of the implementation of the Liquidity Coverage Ratio (LCR) in 2015 and the Net Stable Funding Ratio (NSFR) in 2018 (Appendix Table 2). Between 2013 and the implementation of these new ratios, CRD 4 requires firms to maintain adequate liquidity buffers, sufficient to meet net liquidity outflows under stressed conditions over a short period of time. Across Europe, a number of countries, including France and the UK, are introducing tougher liquidity requirements to operate during this transition period. But many banks have raised the alarm over the dwindling pool of 'high quality liquid assets' which will meet these rules – particularly in light of current sovereign debt volatility. French banks are also concerned with the definition of high quality liquid assets, as many banks invest heavily in units of mutual and monetary funds, which do not qualify. Though banks are working to diversify their liquidity portfolios in order to comply with the current form of the new requirements, many are looking to the observation period to effect changes which will reduce the cost and increase the practicality of meeting the broader objective of enhancing liquidity coverage.

Banks will need to keep track of, and input actively into, EBA processes for developing the large number of binding technical standards required to implement CRD 4 at the detailed level

Finally on CRD 4, banks will need to keep track of, and input actively into, EBA processes for developing the large number of binding technical standards required to implement CRD 4 at the detailed level. These standards will also have to reflect the significant increase in reporting requirements set out in CRD 4, and banks will need to consider how they will be able to integrate these requirements with other changes in regulatory reporting and data management.

But CRD 4 is not the only driver of additional capital for Europe's largest banks. Seventeen of the twenty-nine banks designated by the FSB to be G-SIBs

are European, and will be subject to a capital surcharge of between 1 and 2.5 percentage points on their minimum core tier one capital ratios. In addition, some combination of EU legislation and national initiatives will result in capital surcharges for national SIBs. In the Netherlands, SIBs have been told to prepare for capital surcharges of between one and three percent, while in the UK the ICB has recommended a minimum 10 percent of common equity tier one capital for the largest ring-fenced retail banks.

Recovery and resolution planning

Following its consultation on Crisis Management in early 2011, the European Commission is expected to propose a Directive by early 2012, setting out requirements for the recovery plans that firms will need to put in place. These are expected to include:

- Information that firms must provide to enable the authorities to draw up resolution plans for each firm
- A common minimum set of powers under which national authorities can require firms to improve their recovery plans and to change in advance their businesses and structures to make them easier and less costly to resolve
- A common minimum set of powers and tools which national authorities could use to resolve a failing firm, including requiring banks to hold a minimum amount of 'bail-in' debt that could be written down at the point a bank is put into resolution by the authorities, and the imposing of levies on banks to pre-fund the provision of official support as part of the resolution of a failing bank.

Based on the consultation exercise, the European Commission may favour applying the requirements to all credit institutions and investment firms, rather than just to systemically important firms. It proposes extensions to national supervisory powers, such as enabling national authorities to replace the management of a bank with a 'special manager' ahead of resolution if the bank's recovery plans have not stabilised the bank. It may also extend the mandate of the EBA directing detailed guidelines on how recovery and resolution planning should operate in practice, and acting as a decision-taking mediator in disputes between home and host authorities. Such a directive would be broadly consistent with the approach to recovery and resolution planning established by the FSB and endorsed at the G20 summit in November; and with the national approaches already being developed in Europe by countries such as the Netherlands, Switzerland and the UK.

In these countries the major SIBs have been discussing resolution planning with the authorities, based in part on how the existing operational and legal structures of SIBs might hinder effective resolution through the use of shared services and outsourcing across a banking group, management information systems, intra-group exposures, and the ways in

Each bank will have to determine whether its existing business activities and structures can accommodate the magnitude of reform or whether a step change will be required if the bank is to emerge with a viable franchise

which clearing, payment and settlement systems are accessed. Undertaking detailed internal reviews can be cumbersome and expensive yet they can help in reassessing strengths and weaknesses of existing organisational structures.

The directive would act as a wake-up call to banks in many European countries which have so far made only limited progress on resolution planning. These banks will have to provide extensive information to national resolution authorities and then face the prospect of being required to make significant changes to their operational and legal structures and to their business activities in order to satisfy the authorities that they could be resolved effectively if necessary. Even in countries where more progress has been made on resolution planning, such as the UK and the Netherlands, banks will have to adjust to differences between their evolving national regimes and whatever a directive might contain, including any required "bail-in" debt and any pre-funding of national resolution funds.

Internationally active banks will have a particular interest in cross-border arrangements, both within the EU and globally. Such banks will face major challenges in responding to any divergences in requirements, and any lack of cooperation and consistency in their application, both inside and outside of the EU. These divergences may include the stresses and scenarios that a recovery plan should cover; the detailed information to be provided within resolution packs; which financial and economic functions should be regarded as being critical; the extent to which national authorities will require firms to change their business activities and their legal and operational structures in advance to reduce the cost and complexity of resolution; and the conditions under which the authorities will trigger a resolution.

Banks will need to consider seriously the impact of these proposals – together with all the other elements of regulatory reform - on their business models and on their legal entity and operating structures. Each bank will have to determine whether its existing business activities and structures can accommodate the magnitude of reform or whether a step change will be required if the bank is to emerge with a viable franchise. In particular, banks will face higher costs and constraints on their business from the need to develop and report their recovery plans and resolution packs; to make changes to improve the credibility and effectiveness of their recovery and resolution planning; higher funding costs arising from the potential 'bailing-in' of a wide range of unsecured and uninsured creditors, and a likely shift by creditors to providing funding on a secured basis; and possibly the pre-funding of a new resolution fund and the additional funding that would be required if this fund proves to be inadequate.

The UK Independent Commission on Banking

The UK made an early start on the journey towards more resolvable banks, with pilot RRPs and a new resolution regime but with the final proposals of its Independent Commission on Banking (Appendix Table 5) it moves the debate on in a direction which non-UK banks ignore at their peril. The ICB proposes fundamental restructuring as a permanent fixture of UK financial services. It suggests that retail and SME deposit taking should be ring-fenced into separate legal entities which are for the most part financially and operationally separate from the rest of the group. They can, in effect, be 'unplugged' and carry on in the event of wider group or market stress. In addition, it proposes higher capital requiremernts for ring-fenced banks (up to 10 percent for the largest institutions), additional loss absorbing capital (eg. bail in debt) up to 17 percent of risk weighted assets, preference for all depositors of ring-fenced banks in the event of resolution and finally a capital penalty of up to 3 percent on all UK banks if their RRPs lack credibility. If implemented, UK banks will have to make sweeping changes to governance and legal structures, operations, technology and reporting obligations. But more importantly, banks face a strategic challenge to determine their optimal business model in response to these constraints.

Though policy makers elsewhere gave it little support when it was first proposed in Autumn 2010, the ongoing turbulence and crisis in the sector has caused some supervisors to revisit their initial position. Individual countries, including the Nertherlands and Germany, are considering the implications of taking a similar position and in November 2011 the European Commission announced that it will examine potential structural changes, *The UK made an early start on the journey towards more resolvable banks, moving the debate on in a direction which non-UK banks ignore at their peril*

including the separation of retail and investment banking, with its conclusions expected in mid-2012.

Wholesale market structure

Derivatives remain high on the global reform agenda. Two key proposals were introduced by the EU in 2011 to address G20 requirements to standardise derivatives trading; trading through exchanges where possible, central clearing of most derivatives and reporting of all derivatives trades to trade repositories. The first of these is the European Commission's review of MiFID 2, issued in two parts – a regulation under directive – on 21 October.

The regulation ("MiFIR") proposes that standardised trades be traded on one of three regulated trading venues: a Regulated Market, a Multilateral Trading Facility (MTF) – which were defined in the original MiFID – or a newly created Organised Trading Facility (OTF), specifically defined to capture the large volume of trades which have previously been traded bilaterally by brokers and have not been subject to specific supervision and reporting requirements.

MIFIR also extends transparency requirements for posting pre- and post-trade quote and execution prices from equities to other cash asset classes. It extends supervisory powers to monitor activity and potentially suspend, limit or ban some trades and it would force non-discriminatory access to clearing for derivatives. Investor protection proposals, which is explored below under 'customer protection', remain in the directive ("MiFID"), which is subject to national implementation, along with authorisation and organisational requirements for trading venues and financial service providers.

The second key policy, the European Market Infrastructure Regulation (EMIR) will also drive a significant shake up in the derivatives markets. Initial EMIR proposals (at the time of writing, final European Commission proposals have yet to be issued) envisage increased central counterparty (CCP) clearing (though it is not mandated), and require the reporting of all derivatives trades through to trade repositories in order to increase transparency of market activity and participants. CCP clearing should impose robust risk management practices, improve market liquidity and efficiency and reduce systemic risk. However, it is anticipated that CCP clearing will drive a significant increase in the cost of derivatives, putting pressure on margins. Costs will rise due to increased capital, collateral and margin requirements. In addition, increased reporting requirements and enhanced booking and risk management procedures will force up operating costs. Many products - and potentially many investment banking businesses – may no longer be sustainable in the face of these new costs when combined with the significantly higher capital costs for trading assets under Basel 2.5.

Though MIFID/R and EMIR form the core of European proposals impacting derivatives, European financial institutions must also have regard to similar proposals in the US (the Dodd Frank Act), which are described in the US Perspective. The rules being drafted by the US supervisors are currently intended to apply to any derivatives trades undertaken by a US headquartered financial institution anywhere in the world (so non-US counterparts to these will be subject to US rules) and when dealing with any US counterparty anywhere in the world.

There will be much debate on the regulation of wholesale markets before a final framework is agreed – and much of the detail will be left to the European Securities and Markets Authority (ESMA) to write and implement. The key questions to be answered are: which market participants will be in scope – and the structure of any exemptions for nonfinancial institutions or non-bank financials such as pension funds; the type of derivatives in scope –the US has, for example, exempted spot foreign exchange trades from its scope; the detail of new reporting requirements; any additional risk management and governance requirements, including minimum margin and collateral requirements for bilateral or cleared trades; and finally the scale of convergence in principle, and in detail, of rules across major financial markets.

Customer Protection

The G20 meeting in Cannes mentioned the need to improve consumer protection, but a combination of EU and national initiatives represent a significant push towards greater consumer protection within EMA.

At the EU level, the existing MiFID forms the cornerstone of Europe's approach to investor protection. The proposed revisions to MiFID extend these, strengthening requirements for investment firms when conducting due diligence and disclosure to clients to confirm client classifications. It also sets tighter limits on execution-only sales to retail customers and enhances product suitability measures throughout the product life-cycle. On an ongoing basis, firms must issue annual reports confirming how they have met best execution requirements and comply with tougher rules on safeguarding client assets and restricting opportunities for 'opt outs' from client asset protection. Moving forward, supervisors will have power for additional scrutiny of cross-selling and product bundling practices – a major driver of profits in the past.

MiFID 2 proposals would also ban commission for independent advisers, but say nothing about non-independent advisers, and are limited to mutual fund products, which could lead to confusion for customers. However, individual countries are setting their own rules, and some have already moved ahead and beyond current European proposals. The UK Treasury has said that it wanted to make the ban on commission more robust, and argues that the ban in MiFID 2 should apply to all advisers as the FSA proposes in the Retail Distribution Review (RDR), which comes into effect in 2013.

Denmark and the Netherlands have taken a unilateral view on investor protection regulation, with the latter planning a total ban on commission

Rebuilding consumer confidence in the markets remains a key objective, and many of the proposals at both EU and national level will go a long way towards achieving it. But the constraints and cost will come at a price...

payments to distributors, whether or not sales are advised. Levelling the playing field and closing any loop-holes is crucial in order to improve customer protection and limit opportunities to arbitrage between products, activities and distribution channels.

The European Commission is expected to finalise legislative proposals on Packaged Retail Investment Products (PRIPs) early next year. These are expected to focus on the harmonisation of pre-contract disclosures and greater alignment of sales rules across Europe.

The UK FSA, and the Financial Conduct Authority (FCA), which will soon replace it on conduct matters, has already announced a more interventionist approach to conduct which will place more emphasis on pushing product providers to focus on suitability, transparency and fairness at the product and distribution design stages. The mis-selling of Payment Protection Insurance (PPI) in the UK for example, for which banks have set aside more than GBP 7 billion for redress, will be the sort of conduct issues the new Financial Conduct Authority (FCA) will seek to prevent rather than redress by intervening at a much earlier stage. Banks in the UK are currently trying to evidence what their PPI sales processes were over the last few years. Some banks have struggled to find the documentation, brochures or internet pages that supported the sales process less than five years ago. Substantial improvements in the documentation of product development, distribution and maintenance will be high on the supervisory agenda.

Rebuilding consumer confidence in the markets remains a key objective, and many of the proposals at both EU and national level will go a long way towards achieving that. But the constraints and cost will come at a price, and banks are likely to fight hard for the most profitable segments of the market – which could leave less attractive groups facing limited choice and higher costs for basic services.

Governance

Governance and remuneration have been high on the regulatory agenda since the financial crisis. The responsibilities of a bank's Board and senior management, and the effectiveness of its internal controls and internal audit function have been subject to much closer scrutiny. The principles are familiar: more evidence; more accountability; more effective monitoring and more rigorous supervision. Banks will need to give careful consideration to ensuring that they comply with the various EU-wide and national initiatives in these areas, some of which could require substantial changes to governance and internal control frameworks.

At the EU level, the greater emphasis on governance has been clear over the past year from the green paper on corporate governance issued in April 2011, the corporate governance requirements included within CRD 4 and MiFID2, and the updated and expanded guidance on internal governance issued

Many banks have reduced the variable component of pay and increased the fixed element of compensation in some business areas. However, a recent report by the FSB reveals that bonuses still account for the majority of total pay awarded to UK banks' highest-paid employees

by the EBA that banks must implement by 31 March 2012.

CRD 4 includes new requirements on the boards of banks to take overall responsibility for strategy, risk appetite, internal governance and effective oversight of senior management; and to establish effective risk, nomination and remuneration committees. Non-executive directors are required to devote sufficient time to performing the functions of the board, with specific limits imposed on the number of directorships that may be held by an individual (an upper limit of one executive directorship with two non-executive directorships, or four non-executive directorships); and the functions of chair and chief executive should be separated.

The EBA's updated guidelines on internal governance include new material on the transparency of the corporate structure; the role, tasks and responsibilities of a board's supervisory function; and IT-systems and business continuity management. It will develop binding technical standards on the assessment of the fitness and probity of members of the board, and undertake a benchmarking of board diversity practices.

At the national level, The UK's Walker Report on corporate governance in banks was published in November 2009, the principles of which were subsequently adopted by the FSA and are currently being implemented. Ireland has introduced new regimes for banks and insurance companies for both corporate governance and fit and proper requirements, based on binding rules rather than "comply or explain" guidance.

Remuneration

The FSB's remuneration principles are being implemented through national requirements across the region. In Switzerland, the Swiss Financial Market Supervisory Authority (FINMA) enacted a remuneration policy in 2010. This sets minimum standards designed to ensure that the structure and level of remuneration are aligned with a bank's risk policies and enhances risk awareness, with the variable element of remuneration reflecting long-term performance. In the UK, the scope of the FSA's Remuneration Code has been widened to cover more than 2,500 firms, and while some of the provisions do not need to be applied by the smaller firms there is no complete exemption and every firm has had to conduct a self-assessment for Code compliance. In response, many banks have reduced the variable component of pay and increased the fixed element of compensation in some business areas. However, a recent report by the FSB reveals that bonuses still account for the majority of total pay awarded to UK banks' highest-paid employees.

In Spain, banks are waiting for the issuance of specific remuneration standards, which are expected to align with those established in 2010 by the Committee of European Banking Supervisors (CEBS). The scandal around the high pay, early retirement bonuses and pensions of senior executives of Spain's bank directors came to a head recently with Spanish prosecutors launching a corruption probe into directors of a savings bank, Caja Mediterráneo, a bank that was rescued with €2.8 billion of taxpayers' money.

Supervision and Reporting

Banks in Europe are subject to five broad pressures from supervisory developments, all of which are increasing both their costs and the risk of supervisory interventions in their businesses.

First, the EU supervisory structure changed on 1 January 2011 with the establishment of three new European Supervisory Authorities (ESAs). Compared with their predecessors, the role of these authorities has been considerably enhanced. They have an objective to make supervision across the EU more consistent, powers to draft binding rules and to mediate in disputes among national supervisors, and a leading role in cross-border supervisory initiatives such as the supervision of credit ratings agencies and coordinating the supervision of cross-border firms. Banks will therefore be increasingly subject to a single EU rulebook and to a significant decision-making role for the ESAs.

Second, the supervision of banks has become increasingly intensive, intrusive, forward-looking and judgemental. Supervisors are emphasising stress-testing, reviewing business models and scrutinising corporate governance and remuneration incentives. In this uncertain and shifting landscape, banks need to develop closer relationships with their supervisors and reach a shared understanding of what is required to meet these higher standards.

Third, banks will need to adapt to

The supervision of banks has become increasingly intensive, intrusive, forward-looking and judgemental

changes in supervisory structures in many European countries. In the UK, the current regulator, the Financial Services Authority (FSA), is to be replaced by two new regulatory agencies – a Prudential Regulatory Authority (PRA) located within the Bank of England, with responsibility for the prudential supervision of banks, insurers and major investment firms; and a stand-alone Financial Conduct Authority (FCA) with responsibility for retail and wholesale conduct issues and for the prudential regulation of the 24,000 smaller investment and advisory firms. In France, four banking and insurance supervisory authorities merged to form the Autorité de Contrôle Prudentiel (ACP) in January 2010. The ACP is an independent supervisor operating under the auspices of the Banque de France. In Spain, some changes to supervisory structure may follow the November 2011 general election.

Fourth, a combination of new EU Directives and improvements to supervision has generated an increase in both the amount of regulatory reporting required from banks and more consistent EU-wide reporting standards. CRD 4, MiFID2 and EMIR all require enhanced reporting by banks, in addition to the EBA's Common Reporting Framework (COREP) and Financial Reporting Framework (FINREP) (Appendix Tables 6 and 7). The aim is to harmonise reporting across the EU by mandating a uniform reporting standard and to facilitate data sharing among supervisors and across national borders by establishing a central database for information.

Finally, the development of macro-prudential authorities at the both the EU (the European Systemic Risk Board) and national (for example the new Financial Policy Committee in the UK) levels will result in the active use of macro-prudential tools. The contents of this 'toolkit' however, are still to be defined and many possible options would result in much greater supervisory intervention directly or indirectly, in the operation of the markets. These include setting floors on loan to value ratios and counter cyclical capital buffers. Banks will need to plan carefully for the potential impact of such tools on their businesses.

Financial Transaction Tax

In the aftermath of the financial crisis the idea of taxing banks more heavily has caught the imagination of both politicians and citizens across Europe and, to a lesser extent worldwide. This has been fuelled by a number of concerns including getting banks to pay for the costs of the last crisis, and helping prevent future financial sector distress by disincentivising high volume trading activities which some policy makers believe add volatility and the potential to destabilise markets.

The European Commission proposed in September 2011 to introduce a Financial Transactions Tax (FTT). The tax would apply to a broad range of transactions involving financial instruments, including derivatives, carried out by financial institutions within the EU. This would raise additional revenue at a time when many countries need to reduce their fiscal deficits (the Commission estimated that the FTT could raise €57billion a year), and incentivise banks to reduce their trading activities. However, the FTT would not be confined to transactions between banks – major users of financial markets, such as pension funds, would also be significantly affected.

With the G20 summit in November 2011 failing to support the global application of a FTT, a key issue for the EU will be the risk that financial transactions are booked outside the EU. However, the European Commission's proposals attempt to limit the impact by taking a strict view of when a transaction is undertaken by an EU-based entity.

Experience with collecting Stamp Duty Reserve Tax (SDRT) on transactions in the UK suggests that the implementation process for this tax will be highly disruptive and expensive.

In addition, significant costs will arise with the implementation of the Foreign Account Tax Compliance Act (FATCA). FATCA was signed into law in the US in March 2010, and albeit a US law, it will place a significant burden on many global financial services firms. It was enacted to prevent offshore tax abuses by U.S. persons and includes a new withholding regime that imposes a 30 percent withholding tax on foreign entities that refuse to disclose the identities of U.S. persons. The implications are wide-ranging for financial institutions, investment entities, and many other organizations that operate on a global basis, affecting operations, IT, front office and number of areas of their business.

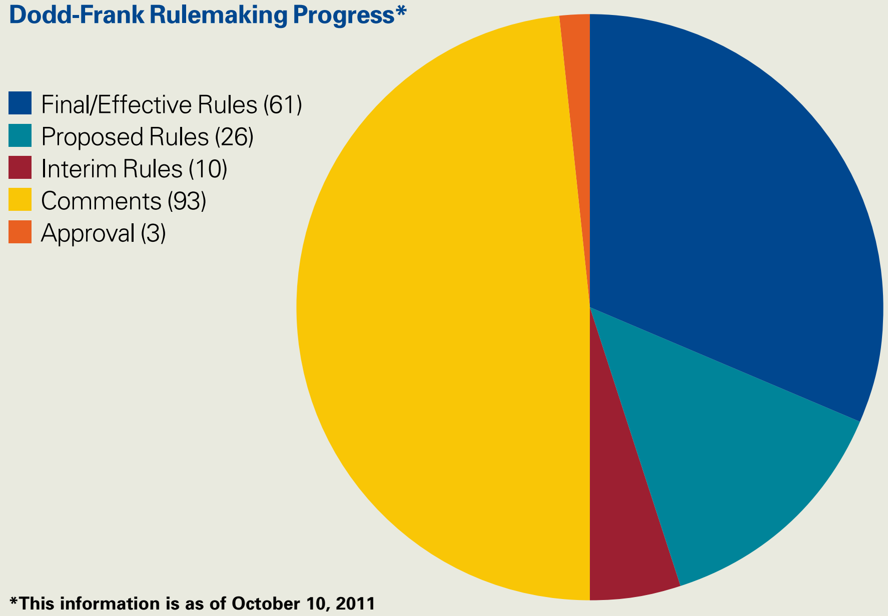
Regional Perspectives: US

The Dodd-Frank Act – the Journey Continues…

Since the passage of the Dodd-Frank Act (DFA) in July 2010, the focus of the Financial Services industry and the regulatory agencies has been on the drafting of over 240 implementing regulations, on topics ranging from consumer protection to the clearing and settlement of derivatives. This is taking place as economic concerns and increased frustration with the lack of job creation has focused negative attention on the financial services industry, which has added to the pressure felt by the regulatory agencies charged with the rulemaking.

During this time, the regulatory agencies have finalized 69 new rules and proposed approximately 28 new regulations still waiting to be finalized. Regulators received numerous comments from the industry on ways to ensure the intent of the DFA is met in a way that has minimal unintended consequences. The rulemaking process has been slower than originally expected and approximately 126 DFA deadlines have been missed by the regulatory agencies as they work through a number of complex issues and continue to deal with ongoing risk management and economic challenges in the financial services sector. Irrespective of the status of the regulation, the current supervisory environment remains challenging for most firms. The number of informal and formal supervisory actions continues to increase, the volume of examination findings have grown, and banks' senior management are spending significant time dealing with regulatory matters.

Dodd-Frank Rulemaking Progress*



***This information is as of October 10, 2011**

On a broader scale, the debate in the US has focused on the proper role of regulation, with some questioning whether current regulatory rulemaking is hampering the economic recovery and potentially putting US institutions on an unlevel playing field with global competitors – especially in the context of the Basel 3 accords.

Most US Financial Services companies have organized a special committee or program management office to follow these developments, assess the potential impact on business models and profitability, provide comments to the regulatory agencies, and help coordinate implementation efforts. However, one thing remains clear: there will be structural changes to the US financial services industry brought about by new regulatory requirements. Many of these changes are intentional, but the consequences of unintended changes will not be known for some time.

Progress to date

Although several of the newly required regulations have not been finalized, a number of key developments mandated by the DFA are in place and are beginning to impact the industry.

In July 2011, a new regulatory agency created by DFA, the Consumer Financial Protection Bureau (CFPB), opened and is now charged with all rule writing and examinations for consumer protection

for all financial services companies – with the exception of banks with less than US $10 billion in assets. In July 2011, the Office of Thrift Supervision (OTS) was merged into the Office of the Comptroller of the Currency (OCC) and the Federal Reserve assumed responsibility for the consolidated supervision of thrift holding companies. A number of interim rules to affect these changes have been put into place to facilitate the transition of supervisory responsibilities.

In September 2011, the Federal Deposit Insurance Corporation (FDIC) finalized resolution plan requirements for banks whose parent company has US $50 billion or more in total worldwide assets. The timeline calls for a phased-in compliance period until the end of 2013, but many firms have already begun assessing the information needed. Lastly, the Financial Stability Oversight Council (FSOC) that was created by DFA, has met several times and approved new regulations for systemically important market utilities eg. payment systems and central counterparties and has issued a report highlighting key risks in the financial system. The FSOC also recently issued a final rule on the criteria that will be used to define nonbank SIFIs that will be subject to Federal Reserve supervision. As an initial starting point, the FSOC will look at any nonbank financial services company with over US $50 billion in assets and apply additional quantitative and qualitative criteria to determine which, if any, companies will be designated as a nonbank SIFI.

Recently, US regulators issued a proposed rule for implementing the restriction on proprietary trading, also known as the Volcker rule. The proposed rule outlines the need for data, reporting, new compliance regimes, and attestations from CEOs, but also asks for input on over 400 rules, so the final rule could differ significantly from the proposal.

Key Areas Yet to Be Finalized

Whilst regulators have finalized several regulations that deal with important aspects of DFA, rules with the biggest potential impact on the industry and profitability are still in progress.

Bank regulatory agencies have yet to finalize new enhanced prudential supervision standards for bank holding companies with total assets over US $50 billion and any organization deemed systemically important by the FSOC.

Many proposed rules have been issued by the regulators to standardise and clear OTC derivatives. However, few rules have been finalized to date and it does not appear that full implementation will start to take effect until the latter part of 2012. The Bankruptcy of MF Global has required significant attention from the regulators and the issues surrounding its customer protection procedures may give rise to additional scrutiny of segregation issues for market participants. In addition, there still appears to be a strong push back from congress over the speed of the regulatory process – and the looming presidential election could add to distraction and drive further delays. During the past few months, bills have been introduced to clarify parts of the Act itself including defining certain aspects of the jurisdictional reach, intercompany transactions and clarifications on the nature of Swap Execution Facilities (SEFs), which will support previously OTC trades.

Rulemaking in the US is complicated by the fact that there is shared responsibility between two regulators – the Commodities and Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). To date, the CFTC has issued proposed rules covering the majority of the OTC agenda. Although some of its rules have been finalized, including a majority of core principles for Derivatives Clearing Organizations (DCOs), significant concerns remain about final capital, margin and segregation rules from the CFTC. In addition, proposed rules as to capital, margin and segregation have not been initiated by the SEC. Lawsuits are starting to evolve over regulation with the Securities Industry Financial Markets Association (SIFMA) and The International Swaps and Derivatives Association (ISDA) suing CFTC over position limits, on the premise that the Position Limits Rule may adversely impact commodities markets by squeezing liquidity and raising price volatility.

One of the current concerns regards the calculation of the minimum amount of capital that needs to be set aside under CFTC proposals for Futures Commission Merchants (FCMs) clearing customer transactions. Many in the industry believe that the proposed rule, 8 percent of margin maintenance, is extremely onerous, especially in light of what is perceived to be much more stringent

margin rules. Many are of the opinion that the current requirement for dealers to post gross margin with each other for bilateral swaps may entice firms to enter into less perfect hedges in the futures and cash markets which may be less costly, though more risky. The final determination of segregation requirements will have a significant operational impact on both FCMs and clearing organizations. In addition, there are concerns about surety of clearance and whether final rules will establish risk procedures to ensure that trades executed will be accepted by the clearing organizations.

The timeline for implementation has yet to be laid out in full by supervisors still struggling to draft and finalize rules. Industry trade associations have suggested a three stage approach for implementation of the regulations. The first stage would equip regulators with market information by the establishment of standardized data, establishing data repositories and reporting requirements; the second stage would reduce operational and systemic risk by requiring Swap Dealers (SD) and Major Swap Participants (MSP) registration, implementing buy side clearing followed by implementing capital and margin rules; the final stage would increase trade transparency by implementing contract markets and execution facilities, including real time trade reporting. This phased approach is likely to take significantly longer than the Financial Stability Board (FSB) requirement to deliver standardization and clearing by the end of 2012– but could be attractive to both politicians and regulators who perceive other jurisdictions to be lagging behind, potentially damaging US competitiveness.

Finally, US regulators have not yet proposed regulations to implement the framework outlined in Basel 3, and will face challenges given the restriction on using credit rating agency ratings in US bank regulations. Nonetheless, capital and liquidity will continue to receive significant attention through the supervisory process.

Tax

The Dodd-Frank Act (DFA) has only one provision that directly speaks to tax matters. However, many of its provisions will have a significant indirect impact on tax issues. The most important of the provisions impacting taxes have to do with the new rules on the clearing, trading and reporting of OTC derivatives, and the provisions dealing with bank capital and living wills.

On OTC derivatives, two areas of likely controversy have been largely eliminated by US tax authorities. First, the DFA specifically directed that the new exchange trading requirement of the act not change the underlying treatment of derivatives under the US tax law. This provision has been implemented by conforming tax regulations. Second, under the DFA, many historic derivative positions may now be submitted for clearing or assigned from one subsidiary of a bank to another, to meet the provisions in the act. The novation or assignment of historic positions raised the spectre that these transactions would be treated as taxable events for the non-assigning counterparty, but existing tax regulations were modified to provide that most of these transactions will not be treated as taxable events.

The restructuring of trading operations as a result of the DFA will likely have tax consequences. To begin with the movement of a trading operation from one banking subsidiary to another may be viewed as a taxable sale of a business, particularly with respect to intangible elements such as goodwill and workforce in place. Further, the movement of trading functions will typically will require a review of transfer pricing policies and a rewriting of service level agreements.

On the impact of the new capital requirements and the need to create living wills, many banks will be reviewing their corporate structures and making changes to them. Any rationalization program that eliminates and / or combines entities will trigger tax issues relating to the restructuring. Finally, as part of their need to enhance capital, some banks will consider the use of “bail in” debt. Bail debt automatically converts to common equity when a bank’s capital levels dip below a prescribed amount or when a bank becomes “nonviable”. The tax authorities will need to decide whether to treat this debt as true debt for tax purposes or as equity.

Supervision

Irrespective of the regulatory agencies efforts on drafting new regulations under DFA, supervisors continue to identify areas that require enhancements or remediation to strengthen risk management and the overall condition of individual banks.

Supervisors, through stress tests and regular examinations, continue to emphasize the need for strong capital and liquidity that is consistent with a bank's risk appetite and ensures adequate capital in adverse economic scenarios. The United States Federal Reserve introduced stress testing in 2009 for federal banks under the Financial Stability Act, the US government's first reaction to the financial crisis of 2007/2008. Accordingly, stress testing was made a permanent provision of the Dodd-Frank Act, section 165(i), requiring a model that links financial circumstances to financial conditions, in financial and non-financial institutions with over US $10 billion in assets. These scenarios are then defined that capture specific stressful circumstances and the model is used to estimate their effect on the institution's capital, liquidity, cashflow, and income. Banks have already begun preparing for the increased oversight and regulation that the Dodd-Frank Act brings, however all agree the regulation can be described as a bit excessive.

The Federal Reserve announced that it is preparing to conduct a fourth round of stress tests and the end of 2011 to determine if U.S. banks can withstand a recession. The increased downside risk that Europe's debt crisis poses to financial markets and the global economy all play a factor in the U.S. banks' stability. This fourth round of test will require more analysis after receiving little guidance over how much distribution to shareholders will be allowed. Risk management and governance activities continue to receive close scrutiny in areas such as model validation, management information systems and reporting, and internal audit. In addition, regulators continue to closely scrutinize efforts around foreclosure activities. Overall, the industry continues to deal with a number of supervisory matters at the same time as trying to assess the ultimate impact of DFA on their business models and profitability, while also dealing with continued challenges in the economic environment.

Expectations for the Coming Year

The debate about the role of regulation will continue in the US, given the 2012 Presidential election. Regulators will continue to propose and finalize the remaining requirements of DFA.

By the end of 2012, industry participants will have a better understanding of how many aspects of DFA already finalized – including the CFPB and resolution planning – will ultimately be implemented and the true impact on their business model and profitability.

DFA and regulatory rulemakings and their consistency with international regulatory reform efforts is likely to be a key area of concern and result in considerably more debates, particularly around Basel 3 capital and liquidity requirements and OTC derivatives, both in the US and globally. Regulators are expected to continue to reinforce the need for strong capital, liquidity, and risk management, and that current issues related to foreclosure activities are well on their way to being resolved. In addition, there will be increased regulatory interest and scrutiny of individual banks' responses to new DFA regulations.

Ultimately, 2012 will be another year of significant change and uncertainty for the US Financial Services industry, as firms continue to make the transition to a new regulatory environment with new rules and regulations.

DFA consistency with international regulatory reform is likely to be a key area of concern, resulting in considerably more debate in the US and globally

Regional Perspectives: ASPAC

Basel 3 Implementation – Capital

Implementation of Basel 2 was in many respects "optional" for most jurisdictions in Asia, as only Japan was a member of the Basel Committee on Banking Supervision (BCBS) and therefore formally required to implement (in practice, however, many jurisdictions still chose to implement, although not necessarily to the letter, and not necessarily according to the BCBS timetable). With Basel 3, the position is somewhat different, as numerous Asian jurisdictions are now members of the BCBS (Japan has been joined by Australia, China, Hong Kong, Indonesia, Korea, and Singapore) and there is therefore an expectation that these countries at least will implement fully, and in accordance with the agreed timetable.

To date, several countries (Australia, China, Singapore) have provided details of how they propose to implement Basel 3, and as regards these jurisdictions at least two general themes are emerging: first, that they plan to require their banks to hold more capital than the new Basel minimums; and, second, that they are going to accelerate the timetable, requiring their banks to comply with key elements of the requirements well before the Basel deadlines.

Given that banks in Asia generally fared very well during the Global Financial Crisis, these themes are perhaps a little surprising, as one might have thought that there would be little need for urgency, or need to exceed the new higher capital minimums. But, given that most or all banks in their jurisdictions can already comfortably meet the new capital requirements, or can meet them comparatively easily and quickly, these regulators have seen no need to delay on implementation.

The story is more mixed elsewhere in the region, however, with some regulators still to announce their timetable for, or details of, the implementation of Basel 3.

At least two general themes are emerging: first, that these countries plan to make their banks hold more capital than the new Basel minimums; and, second, that they are going to accelerate the timetable

There are some fundamental issues with implementation of the new Basel liquidity ratios in Asia

For example, some such as the Financial Supervisory Commission (FSC) in Taiwan have stated that they are studying the adoption of Basel 3 and its impact on regulatory capital requirement, but no schedule has yet been announced. This is similar to the Bank of Thailand, which is currently in the process of performing capital and liquidity impact assessments, but has not developed an official timetable for Basel 3 implementation, and the approach of Korea's Financial Services Service (FSS). In Indonesia, an official working group has been established to address Basel 3 but has yet to publish proposals.

A comparison of the new capital requirements under Basel and current requirements in selected Asian jurisdictions is set out below. In Australia's case, the regulatory announcements incorporate several national discretions that are more demanding (ie. that have the impact of lowering reported capital ratios) than the requirements of Basel 3. This seems to suggest that some Asian regulators at least will be treating all their major banks more or less as if they were SIFIs.

Liquidity

As with capital, several regulators in the region (most notably Australia, China and Hong Kong) have already announced how, in principle, they propose to implement the new Liquidity Coverage Ratio (LCR) (although some details are not yet fixed).

It is clear from these regulators' proposals, and others, that there are some fundamental issues with implementation of the new Basel liquidity ratios in Asia. These include:

- There may not be enough liquidity to meet the Basel definition in some markets (this is something the BCBS is aware of, and is reviewing);
- Thirty days may not be the most appropriate time horizon for the LCR. In Asia liquidity problems have historically emerged more quickly, such that banks and regulators in many markets focus on a much shorter time period, such as seven days. Likewise, the assumptions regarding run-off rates implicit in the Basel ratio may be quite out of line with the Asian experience;
- There are a significant number of foreign institutions in Asia that are funded largely or partly intra-group, and the treatment of intra-group funding under the LCR (when local regulators apply it on a sub-consolidated basis) is such that this funding model causes difficulties in meeting the 100 percent LCR coverage requirement; and
- The currency composition of cashflows and liquidity holdings is more of an issue in the Asia Pacific region, as it is relatively common for deposits and lending to be conducted in more than one currency (typically the US dollar in addition to the local currency, while in some markets the Renminbi (RMB) is also becoming significant).

Given the above problem areas, many regulators in the region are adopting a (possibly very wise) "wait and see" attitude until there is more clarity on how these issues can be resolved. There is also a feeling that perhaps some changes to the LCR may be forthcoming from Basel which will help address some of these Asia-specific issues.

	CET1	T1	Total
Basel	7.0	8.5	10.5
Basel G-SIFIs (Max)	9.5	11.0	13.0
Australia	7.0	8.5	10.5
China (Major Banks)	8.5	9.5	11.5
Singapore	9.0	10.5	12.5

Regulators in the ASPAC region (particularly Australia and Japan) are now starting to require banks to prepare RRPs, and the expectation is that, over time, more are likely to do so

Risk management benefits of adoption of Basel 2/3

A primary objective of Basel 2 was to raise risk management standards among banks, by encouraging them to adopt "sound practices" with regards to risk management, and to adopt more advanced, model-based approaches to managing risk where appropriate.

In many markets in Asia, the full benefits of Basel 2 were never realised, as not all banks adopted Basel 2 or were required by their regulators to do so. Many opted for the simpler, rather than the more advanced approaches.

Several regulators in the region have said that they see the development of Basel 3 as an opportunity for their banking systems to "catch-up" with banks elsewhere in terms of risk management. For example, the Indonesian Central Bank has been issuing Basel 2 regulatory requirements during this and last year, whilst in Korea, a number of banks are preparing applications for Internal Ratings Based (IRB) recognition from the FSS. The Chinese regulator, the China Banking Regulatory Commission (CBRC), which had previously applied Basel 2 only to the very biggest banks, has said that all banks in China will now be required to implement both Basel 2 and 3. There are suggestions that some other jurisdictions will also take such a bold approach. This is to be welcomed, as global financial stability should be significantly strengthened if more and more banks and banking systems globally can implement these enhanced standards.

Recovery and Resolution Planning

Regulators in the region (particularly Australia and Japan) are now starting to require banks to prepare RRPs, and the expectation is that, over time, more are likely to do so (at least one bank in China will be required to do so, for example, a requirement of being a G-SIFI).

- The Australian Prudential Regulation Authority (APRA) has commenced a pilot exercise on recovery planning with six large deposit-takers that will incorporate Board-level engagement and the submission of finalised plans in 2012.
- The Japanese Financial Services Agency (JFSA) has instructed its G-SIFIs to commence preparing documentation required for an RRP. In the case of Japanese G-SIFIs, which tend to have fewer subsidiaries/affiliates, and are usually managed on an entity rather than product line basis, the burden of RRP documentation would likely be easier compared to their Western counterparts. They continue however to closely monitor the global discussions in relation to RRPs.

There are possibly several reasons why there are signs of activity on this from Asian regulators. First, ASPAC is responding to the FSB requirement for RRPs on G-SIBs, four of which are in ASPAC, and its expectation that this will extend to national SIBs. Second, the opinion appears to be that the RRP exercises conducted in the US and UK have proved quite successful, and therefore the technique should be used more widely. Third, there is perhaps a feeling that supervisors in Asia need to have more information about what banks' plans (particularly foreign banks for their Asian operations) might be, were there to be a recovery or resolution situation.

Restructuring of Asian operations

Several of the major global (commercial and investment) banks are reviewing their Asian operations (strategy, business model, legal entity set-up) in the light of new regulatory requirements. Clearly, Asia remains a key area of growth for many, so it is natural for them to examine whether their business set-up is optimal to maximise business opportunities.

US Treasury Secretary, Tim Geithner, was recently quoted as asserting that all regulators needed to follow the US lead on higher standards, as financial institutions may seek to do business in the most lenient jurisdictions. While this view was promptly rebuffed by then CEO of the Hong Kong securities regulator, Martin Wheatley, it is clear that "regulatory arbitrage" is something that will attract more focus. Certainly, on the basis of the above, it is evident that many regulators in the region have been more stringent on capital requirements than the Basel minimum and are accelerating implementation. Therefore, there appears currently to be little evidence that Asian jurisdictions are competing for business on the grounds of lax regulation, or are likely to do so. Indeed, many Asian regulators, particularly in China, are making a significant contribution in global regulatory circles.

Enhancing the corporate governance of financial institutions might be seen as a side-objective of new Basel requirements, but in many Asian jurisdictions enhancing corporate governance is seen as one of the regulator's key objectives

Corporate governance

Enhancing corporate governance of financial institutions might be seen as a side-objective of new Basel requirements, but in many Asian jurisdictions enhancing corporate governance is seen as one of the regulator's key objectives. For example:

- A key theme of the Malaysian authorities' Capital Market Masterplan 2 (CMP2), released in April 2011, in addition to developing and growing Malaysia's capital markets, is the further strengthening of corporate governance with particular emphasis on qualifications and knowledge, board composition and on enhancing independence.
- The Monetary Authority of Singapore enhanced the corporate governance framework for locally-incorporated banks in December 2010, taking into account valuable lessons on corporate governance arising from the recent financial crisis, covering among other things director independence and appropriate remuneration policies.

As ASPAC's role in global financial markets continues to grow in line with its broader contribution to the global economy, pressure is expected to continue to ensure governance principles of independence, accountability and effectiveness are put in place.

Wholesale Markets

Several countries in Asia Pacific have launched consultations or announced measures in relation to OTC derivatives reform, including Hong Kong, Japan and Korea.

In Japan, the Financial Services Agency (FSA) introduced several reforms to avoid systemic risks in the derivatives market after the Lehman-shock. The FSA responded by reforming the Financial Instruments and Exchange Law (FIEL) in 2010 with the objectives of:

- Improving the stability and transparency of the settlement of OTC derivative transactions
- Strengthening the securities clearing and settlement systems, including for government bond transactions and stock lending transactions
- Consolidating the regulation and supervision of securities companies
- Increasing hedge fund regulation
- Stabilising the market with the development of a reporting system for short selling

However, the FSA's main focus seems to be on growth and the expansion of the Japanese market. In fact, implementation of the G20 and Basel requirements in respect of OTC derivatives in Asian jurisdications is not a straightforward matter, as markets are generally small and the transactions conducted tend to be less sophisticated. This suggests that some tailoring of the G20/Basel requirements to local circumstances would be appropriate. As an example, Hong Kong intends to introduce mandatory reporting of certain products to a trade repository being set up by the Hong Kong Monetary Authority (HKMA) and mandatory central clearing through a designated central counterparty (CCP), but will not introduce initially the requirement for trading on an exchange or electronic trading platform. Other jurisdictions are also looking at how best to implement the requirements in their own market, given local characteristics.

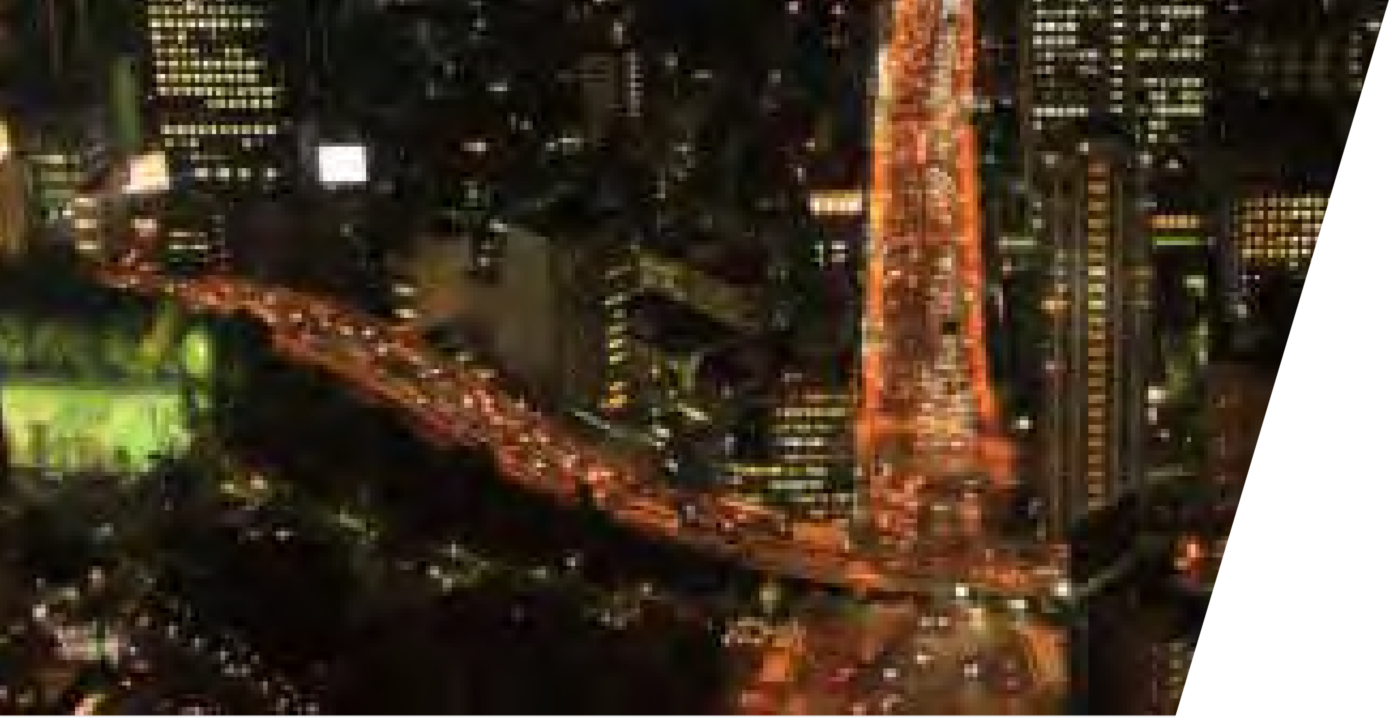
A clear concern emerging is of potential conflicts between local requirements and other centres' requirements, particularly if there is not international agreement on mutual recognition of CCPs (domestic or regional). Perhaps as a result, the FSB noted that many developing markets appear to be waiting to set their own standards until final rules in the US and EU become more clear. The concern would appear to be particularly marked in relation to dealings with US institutions, and in relation to Dodd-Frank issues.

Other "Asian" regulatory issues

With all the focus on Basel 3, it is easy to lose sight of the fact that there are numerous other regulatory issues facing banks in Asia.

A challenge that applies to several jurisdictions, but primarily to Malaysia, is the challenge of developing an approach to Islamic Finance, for example:

- The harmonization of regulations, guidelines, and operational requirements between the Islamic and conventional systems, as well as between the various Shari'ah schools.
- The development of a self sufficient Islamic finance infrastructure, such as a fully functioning global liquidity market



and system, as well as a central regulatory standards body.
- Liquidity is likely to be the key challenge for Malaysian institutions generally, but particularly in the case of Islamic financial institutions.

Another example of the differing issues facing regulators in Asia is the case of New Zealand, where:

- The four largest banks are all subsidiaries of Australian groups, and hence the regulator, the Reserve Bank of New Zealand (RBNZ), has to co-ordinate its approach and implementation of Basel 3 with the Australian regulator, APRA.
- Banks have already recently implemented a new liquidity core funding ratio which, although different to the Basel 3 liquidity requirements in form, is similar in substance, and therefore no further change in liquidity requirements is likely to be made in the near term.
- There is an "open bank resolution" policy under development which addresses certain recovery and resolution type issues.

Customer treatment issues are also on the agenda in several Asian markets, including new regulation on sale of investment products. For example, to strengthen fair dealing in the sale and advisory process of investment products, the Monetary Authority of Singapore has enhanced its regulatory regime for listed and unlisted investment products with new requirements for intermediaries to formally assess a retail customer's investment knowledge and experience before selling specified investment products to customers. These new measures are aimed at ensuring that intermediaries recommend suitable investment products to customers, particularly those who may not have the relevant investment knowledge or experience.

The regulators in Hong Kong have taken similar action in respect to their own market. In Thailand, the Securities and Exchange Commission continues to make progress in implementing initiatives under a four-year "capital markets development plan", covering topics including market entry and permissible products.

A final regulatory area worth mentioning that is exercising many in Asia is FATCA. For example, Taiwan's regulators including the FSC and Taiwan Bankers Association are known to be closely watching developments related to FATCA. The controversies include conflicts of law such as with the Personal Information Protection Act, and in fact there is no tax treaty between Taiwan and the US. The Taiwan Bankers Association also advises that there will be a huge impact on current systems and operations just to identify US citizens in compliance with the US requirement.

This "conflict of law" situation is something that is common across many Asian jurisdictions – and is an example of the challenges institutions face in trying to ensure their compliance with sometimes conflicting requirements covering topics including market entry and permissible products. Institutions face similar potentially conflicting requirements in relation to OTC derivatives reform.

In a number of countries, regulators are making reforms of their risk based capital frameworks for insurance companies. This may also impact the risk management expectations and requirements of banks because of their ownership of insurance subsidiaries. In addition, International Financial Reporting Standards (IFRS) accounting standard reforms are occurring in several jurisdictions.

Appendix

Table 1

Basel 3

The G20 endorsed the Basel 3 capital and liquidity requirements at their November summit in 2010. The core principles include:

- Increased quality of capital
  – Common equity and retained earnings should be the predominant component of Tier one capital.
- Increased quantity of capital
  – Total common equity requirements 7.0 percent (Minimum common equity Tier one 4.5 percent plus capital conservation buffer of 2.5 percent)
  – Minimum total capital 10.5 percent (including conservation buffer)
- Reduced leverage through introduction of backstop leverage ratio
  – The leverage limit is set at 3 percent
- Increased short-term liquidity coverage
  – The LCR is intended to promote short-term resilience
- Increased stable long-term balance sheet funding
  – The Net Stable Funding Ratio (NSFR) incentivises banks to reduce reliance on short-term wholesale funding.
- There are significant increases in reporting requirements set out in the Regulation.
- The use of a 'maximum harmonisation' Regulation means that national authorities will not be able to apply higher capital ratios and risk weightings across the board.

Table 2

The Liquidity Coverage Ratio (LCR)

The LCR is designed to ensure that banks can survive a short-term, 30 day liquidity crisis. From January 2015, banks will be required to maintain this ratio at or above 100 percent. The ratio is defined as:

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}}$$

High quality liquid assets are split into two components:

- Level 1: highest quality assets that are not subject to haircuts ie central bank reserves and government debt.
- Level 2: assets that are subject to a haircut and can include corporate bonds and covered bonds. These can only comprise a maximum of 40 percent of the required stock.

Total Net Cash Outflows are defined as the total expected cash outflows minus total expected cash inflows for the next 30 calendar days.

Table 2 (continued)

The Net Stable Funding Ratio (NSFR)

The NSFR is designed to promote more medium and long-term funding. From January 2018, banks will be required to maintain this ratio at or above 100 percent.
The ratio is defined as:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}}$$

Stable funding is defined amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress:

1) capital;
2) preferred stock with maturity of equal to or greater than one year;
3) liabilities with effective maturities of one year or greater; and
4) that portion of stable non-maturity deposits and/or term deposits with maturities of less than one year that would be expected to stay with the institution for an extended period in an idiosyncratic stress event.

Table 3

CRD 4

The European Commission published a proposed Regulation and Directive in July to implement the Basel 3 package of enhanced risk weightings and capital and liquidity standards. The Directive also includes proposals on corporate governance, minimum administrative sanctions, reliance on credit ratings and collaboration and information sharing among national supervisors.

The Regulation and Directive are expected to come into force at the beginning of 2013 (with full implementation phased in between 2013 and the beginning of 2019).

- CRD 4 requirements mirror Basel 3 on capital and liquidity standards, and higher risk weightings on trading book assets and counterparty exposures. It follows Basel for the phasing in of higher capital standards and for the initial 'observation periods' and parallel running of the new liquidity ratios and leverage ratio.
- The Directive contains some new requirements on corporate governance, including specific limits on the number of directorships that an individual may hold.

Appendix

Table 4

Financial Stability Board

The FSB's policy framework for SIFIs proposals include:

- SIFIs and the authorities should have a resolution framework in place to ensure that they can be resolved quickly and without destabilising the financial system.
- International Recovery and Resolution Planning (RRPs) should be mandatory for Global SIFIs (G-SIFIs).
- G-SIFIs should have higher loss-absorbency capacity than the minimum levels agreed in Basel 3.
- SIFIs should be more intensively supervised.
- Financial market infrastructures should be robust enough to reduce contagion from the failure of one SIFI
- International supervisory colleges should assess the risks facing G-SIFIs.

Table 5

UK Independent Commission for Banking (ICB)

The ICB published its final recommendations in September. The key recommendations include implementing a ring-fence around retail banks, imposing additional capital requirements and increasing competition in the industry as follows:

- UK retail banks to be ring-fenced, with dedicated operational and support services, arm's length relationship with wider group, and independent Board.
- Large ring-fenced retail banks to hold equity capital of 10 percent, plus another 7-10 percent of loss absorbency through contingent convertible capital (CoCos) and bail-in debt.
- This additional loss absorbency also to apply to globally important UK banking groups.
- Lloyds Banking Group (LBG) branch divesture to generate a new entity with at least 6 percent of current account market.
- Free, rapid and efficient switching mechanism for current accounts.
- Financial Conduct Authority (FCA)'s primary objective to promote effective competition in financial services.

Table 6

Common Reporting Framework (COREP)

The European Banking Authority (EBA), will implement a common reporting framework (COREP), from 1 January 2013. Its aim is to harmonise reporting across the EU by establishing a uniform reporting standard and to ease data sharing amongst regulators and across national borders by establishing a central database for information.

In the UK, COREP will replace current FSA reporting requirements in key areas, particularly concerning capital adequacy, securitisation, credit risk, market risk and operational risk. However, the exact parameters of COREP – the final templates and requirements – will not be fully finalised until Q3 2012.

Nevertheless COREP will cause major changes to firms' reporting requirements meaning that they cannot afford to be complacent. Under COREP banks will face the following changes:

- A dramatic increase the volume of data they are required to report.
- A change in the quality of the data reported to cope with increasingly intrusive supervision.
- A noticeable increase in the speed of report writing to meet an increase in reporting frequency and reduced remittance windows.
- A change in the format in which reports are submitted. BY 2013, banks in the UK will have to provide harmonised reports in XBRL rather than XML taxonomy.

Table 7

Financial Reporting Framework (FINREP)

FINREP works in tandem with COREP in pursuit of the EBA's goal of attaining a high degree of harmony in regulatory reporting across the EU. In December 2009, the Committee of European Banking Supervisors (CEBS), which became the EBA in January 2011, issued significant revisions of the existing FINREP framework, created in 2006. These revisions will become operative as of 1 January 2013.

Like the 2006 framework, the revised FINREP will continue to apply to credit institutions preparing their supervisory returns under IFRS. However, there are several key changes which firms and regulators need to take note of:

- Data Requirements: In contrast to current guidelines which only laid down minimum requirements, FINREP will now set both minimum and maximum data requirements with the aim to reduce the reporting burden of banks. The maximum framework consists of two CORE templates which must be implemented and twenty-three non-CORE templates to be implemented at the discretion of the national authority. It should be noted that national regulators may not amend the maximum and minimum standards.
- Reporting Frequency: Whereas reports are currently produced annually, under new framework national regulators have the ability to demand reports quarterly, semi-annually or annually.
- IT Systems: The EBA highly recommends the use of XBRL taxonomy in FINREP reporting.
- FINREP Application: Although FINREP will not be mandatory across EU member states, the EBA is instituting a 'comply or explain' provision whereby those regulators that do not use FINREP have to give make clear their precise rationale for not using it.
- Forthcoming changes: Firms and regulators should note that there will be yet another, third revision, to FINREP requirements at the end of 2011. The application date of FINREP rev 3 is set at January 2013.

Like COREP, firms need to take a pro-active approach in their response to the changes to FINREP. In particular, the potentially increased frequency of financial reporting that is allowed under these provisions will require firms to be more efficient in their data collection and processing.

Of particular note to firms operating under the supervision of the FSA, which has thus far opted not to use FINREP, is the stricter approach that the EBA has taken towards the adoption of FINREP.

Abbreviations

ACP	Autorité de Contrôle Prudentiel
APRA	Australian Prudential Regulation Authority
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
BCBS	Basel Committee on Banking Supervision
Cam	Caja Mediterráneo
CBRC	China Banking Regulatory Commission
CCPs	Central Counterparties
CEBS	Committee of European Banking Supervisors (note: CEBS became the EBA in January 2011)
CEE	Central and Eastern Europe
CFPB	Consumer Financial Protection Bureau
CoCos	Contingent Convertible Capital
COREP	Common Reporting Framework
CRD 4	Capital Requirements Directive 4
DCO	Derivatives Clearing Organization
DFA	Dodd-Frank Act
EBA	European Banking Authority
EMA	Europe, Middle East and Africa
EMIR	European Market Infrastructure Regulation
ESAs	European Supervisory Authorities
FATCA	Foreign Account Tax Compliance Act
FCA	Financial Conduct Authority
FCM	Futures Commission Merchant
FDIC	Federal Deposit Insurance Corporation
FINMA	Swiss Financial Market Supervisory Authority
FPC	Financial Policy Committee
FSA	Financial Services Authority (UK)
FSA	Financial Services Agency (Japan)
FSB	Financial Stability Board
FSC	Financial Supervisory Commission
FSOC	Financial Stability Oversight Council
FSS	Financial Services Service
FTT	Financial Transaction Tax
G-SIFI	Global Systemically Important Financial Institutions
HKMA	Hong Kong Monetary Authority
ICAAP	Internal Capital Adequacy Assessment Process
ICB	Independent Commission on Banking
IFRS	International Financial Reporting Standards
IIF	Institute of International Finance
IRB	Internal Ratings Based
JFSA	Japan Financial Services Agency
LBG	Lloyds Banking Group
LCR	Liquidity Coverage Ratio
MiFID	Markets in Financial Instruments Directive
MiFR	Markets in Financial Instruments Regulation
MSP	Major Swap Participant
NSFR	Net Stable Funding Ratio
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Cooperation and Development
OTC	Over the Counter
OTS	Office of Thrift Supervision
PPI	Payment Protection Insurance
PRA	Prudential Regulatory Authority
PRIPs	Packaged Retail Investment Products
RBNZ	Reserve Bank of New Zealand
RDR	Retail Distribution Review
RRP	Recovery and Resolution Planning
RMB	Renminbi
RWA	Risk Weighted Assets
SA Reserve Bank	South African Reserve Bank
SD	Swap Dealers
SEC	Securities and Exchange Commission
SIFIs	Systemically Important Financial Institutions
UCITS IV	Undertaking for Collective Investments in Transferable Securities IV

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