cutting through complexity

FINANCIAL SERVICES

Evolving Banking Regulation

ASPAC Edition

— Regulation driving business change

February 2014

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ABOUT THIS REPORT

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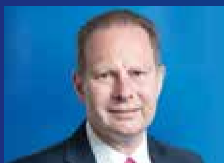

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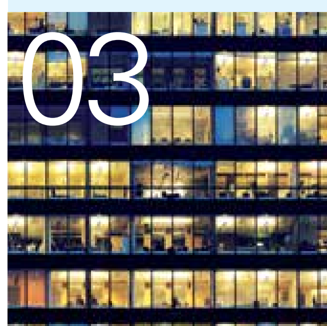

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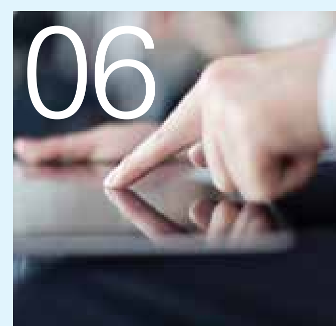

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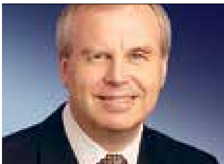
Welcome to this year's Evolving Banking Regulation for the Asia Pacific (ASPAC) region.

Banks are generally moving from the evaluation of regulatory initiatives to implementation, albeit at different speeds and from different starting points. That is why, in this year's report, we focus on five key areas where regulation, combined with other pressures, is forcing banks to make changes. These are: structure; conduct, markets and culture; data and reporting; risk governance; and OTC derivative reforms.

Regulation driving business change



Jeremy Anderson
Chairman Global Financial Services

Looking back over the last 12 months or so, the regulatory reform agenda has notched up some significant achievements. These include the implementation of the framework for Basel 3 in many jurisdictions, including in ASPAC; laying the groundwork to reduce systemic risk through measures relating to the safety and soundness of both banks and market infrastructure and to the effective resolution of failing banks; advancing the wholesale and retail conduct regimes; and setting out the supervisory requirements for assessing risk governance, risk culture and risk data. Taken together, these initiatives could be expected to contribute to a strengthening of the global financial system.

But as we look forward it becomes clear that the regulatory glass is only half full, some six and a half years after the financial crisis began in the summer of 2007. New regulatory initiatives continue to emerge, with no apparent reduction in frequency. Many banks and their regulators have achieved less than they should have done over the last six and a half years. And, particularly in Europe, but perhaps less so in ASPAC, there remains concern that regulatory reforms are hindering the ability and willingness of banks to support economic recovery.

In my discussions with senior bankers and regulators, some serious challenges keep rising to the surface, and seem a long way from being resolved.

Chief among these is that, while banks have gone a long way to meeting the new quantitative requirements set by regulators, for example in relation to capital, liquidity and leverage, they have more to do in meeting regulators' qualitative requirements, covering risk management and areas such as governance, risk appetite and risk culture, which are especially challenging for complex groups.

Cross-border resolution

For all the progress made on recovery and resolution planning, and on developing the 'bail-in' tool, the question of how to resolve effectively a cross-border bank remains unanswered. Indeed, the more that the resolution authorities in some major financial centres (US, UK and Switzerland) press ahead with their preferred version of how resolution and bail-in would operate, the more that 'host' countries, including in ASPAC, take a step back and consider how to protect their local interests in the event of the resolution of a major international bank.

I fear that the end result here will be a further retreat into localisation and balkanisation, with local requirements on the bail-in capacity of the local operations of foreign banks being added to local requirements on capital, liquidity, funding, governance and even subsidiarisation. The senior bankers I speak to, and increasingly their major corporate clients, see this localisation of regulatory requirements as a serious threat to operating a sustainable global business model without adding costs or reducing services to global

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clients. However, when I talk to regulators, particularly host regulators, I can certainly see their point too. Some have commented that they feel they have little choice but to require greater localisation, reduce reliance on outsourcing, and ring-fence local operations, whatever the effects might be on the financial system efficiency locally, regionally and globally.

More regulation to come = continuing uncertainty
The continuing debates on the leverage ratio, internal models, stress tests, and simplicity versus complexity are leaving both bankers and regulators very uncertain about where the regulatory change agenda will come to rest. This makes it difficult for banks to plan effectively.

But it is clear from the direction of travel that there will be further pressures on major global banks to raise more capital to support their business activities, and to exit, re-price or restructure their business lines.

Culture
Globally, there continues to be an alarmingly wide range of retail and wholesale market misdemeanours. This in turn is shifting the focus from detailed conduct rules to the culture and behaviour of banks, with a clear read-across to greater personal accountability, the development and measurement of key performance indicators for culture and behaviour, and further pressure on remuneration and incentive structures.

Data
Banks face a myriad of issues around data quality and management. Data demands are growing all the time, but ensuring these data are fit for purpose remains difficult given the fragmented systems and processes through which the data flow. Good data provide the basis for product design, customer service, risk management and business decisions, but many banks remain seriously constrained by their legacy IT and data systems.

Meanwhile, bank supervisors (and, I would have to say, bank Boards) are becoming increasingly frustrated by the implications of this for the effectiveness of banks' risk management. Supervisory intensity in this area is already on an upwards trajectory, and this can safely be predicted to continue over the next few years. This will hasten progress by the banks in improving their data and risk management, but in a world of limited budgets this may hold back investment on more strategic and commercial projects.

Future of banking
Generally, we see banks restructuring in favour of locally capitalised, funded and client-driven businesses, centred on regional hubs. They are striving to introduce a real client focus at the heart of their businesses, and the right culture and people to deliver this. And they are seeking to rebuild a relationship of trust with their customers, investors, regulators and other stakeholders. But they face a myriad of challenges, including raising capital, maintaining operational efficiency in a world of more ring-fencing autarkic regulation, greater supervisory emphasis being placed on the "softer" but important aspects of risk management such as risk culture, integrating risk appetite meaningfully into risk management, and the increasing pressures on management, Boards and non-executive Directors. These developments are a continuing journey, and those banks that take a bold, direct and simple approach are likely to emerge as the industry leaders in the future.

I hope you enjoy reading this report, and that it provides useful insights which you can apply to your business. ■

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The emerging regulatory requirements – including structural reform, conduct, governance and the possible emergence of 'Basel 4' – are game changing. The banking industry's existing business models are being substantially reshaped.

Executive Summary

The relentless march of the regulatory reform agenda continues. The 'more (and more) of everything' series of regulatory initiatives seems unlikely to abate and will continue to reshape radically the banking sector. While the change is perhaps most marked in Europe and the US, we are seeing knock-on effects on ASPAC, first because European and US institutions are reshaping their activities in the region, and second because these changes in the major markets are having an impact on the regulatory philosophy in many ASPAC jurisdictions too, particularly in jurisdictions which are now members of the Basel Committee, Financial Stability Board (FSB) and G20, and subject to the peer review processes applied by the Basel Committee and FSB, together with IMF Financial Sector Assessment Program (FSAP). An issue this creates, however, is that regulators in ASPAC now have less licence than before to modify international regulatory initiatives in ways that are appropriate to the region.

The waves of regulation are swirling around banks more rapidly than many can manage. This raises the prospect that there will be more casualties before the financial crisis is over. Successful banks will be those who can keep ahead of the storm by meeting the demands of customers, investors and regulators.

The financial stability landscape

The first set of challenges for banks, which this report focuses on, is to meet the current and prospective regulatory requirements on capital, liquidity and recovery and resolution planning (RRP). Banks caught in the headlights of Basel 3 implementation may miss the wider picture here, as Basel 3 transforms potentially into a 'Basel 4' as a result of tougher requirements on the leverage ratio, risk-weighted assets and stress testing.

The report then considers four areas where a combination of regulatory and other pressures is forcing banks to reform their strategy, business and operating models, governance and culture. This will have significant impacts on the customers of banks.

Structure

Regulatory requirements will force major structural change, including the split of global entities into a patchwork of smaller locally or separately regulated subsidiaries. Many banks have already begun to revise their legal entity structures and to reduce and restructure their balance sheets. This, combined with the impact of 'Basel 4', may significantly increase the cost of doing business.

Addressing the myriad regulatory and legal, compliance, capital, liquidity, funding, tax and governance considerations is a complex, multi-dimensional issue. But, in addition, banks must also consider the operational complexities. These complexities are often not considered until the implementation stage, but they can themselves preclude any number of options, or can increase the cost or lapsed time such that some options become unworkable.

Conduct, markets and culture

Much banking practice historically has been 'product push' – focused on the desire to sell rather than a more thoughtful view of what would best suit the needs of the customer. This has contributed in retail banking to the various mis-selling disasters of recent years particularly in Western markets but also, to some extent, in the ASPAC region, and in wholesale markets to the significant and widespread market abuse issues.

Reputationally, this has been a disaster for the banking industry. Financially, the issue has been focused on specific jurisdictions – but however this is measured, it is a depressing picture.

Retail banks want to become customer centric, but are finding it hard to deliver this given legacy systems, culture and the inertia in the industry. Wholesale banks are still getting to grips with what client centricity might mean (given the past treatment of customers for many business lines as counterparties or sophisticated investors). Regulators are looking for radical changes in banks' behaviours.

The regulatory bar has been raised significantly, not only in terms of the outcomes to be achieved but also in terms of the clear articulation of what conduct risk means to a bank, how it is a core part of the strategy, and how clearly articulated and implemented the governance, controls and key indicators are from the boardroom down to front line product design, manufacturing and distribution.

Only really significant change to the DNA, culture and values of banks can rebuild the organisation to meet the needs of investors, customers and regulators. This is reflected in the change programmes of many banks, but this sort of change is much harder than (even) sorting out the core operations.

It is critical that this change is underpinned by a dramatic shift in culture, through tone from the top, policies, hiring practices, incentive structures, embedding values and demonstrating consequences for behaviours which are no longer acceptable. This is a huge boardroom challenge. For many banks only radical surgery will satisfy all these stakeholders – few banks today have a complete answer.

Data and reporting

Banks face three major challenges around data management. They need to hold and use the right data to get much closer to their customers. They have to meet the wide-ranging and significant increases in demands from regulators and others for reporting and disclosures. And they need to respond to supervisory concerns that banks do not have the right data, systems and IT architecture to enable them to understand, aggregate and disaggregate, and manage their risks effectively.

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With home and host supervisors often looking for different aggregations of data, the need to monitor risk at a consolidated level, and the data demands relating to resolution planning and to stress-testing, banks very much have their hands full on data issues.

Meanwhile, banks also need to address the new and unforeseeable risks in data privacy and cybercrime, conflicting national laws and the impact of retrospective investigations in an environment where vast amounts of data are indefinitely available.

Key to these challenges are increasing the maturity of data analytics capabilities; a clear understanding of the ownership, roles and responsibilities for data management (including retention and rationalisation); a clear plan to attack core data quality issues; and the implementation of more flexible technology solutions with greater sharing/re-use and better handling of unstructured data.

Governance and risk

The financial crisis itself, and the problems and challenges discussed above, point to a need to upgrade significantly the governance and risk management of banks. Much work is already underway on this, but much more needs to be done. As banks get to grips with their business strategy, risk appetite, risk culture and management they will need quite different management information which only significant investments in core and critical systems, as well as emerging analytic technologies, will provide. They also need to consider how to form a group-wide view of risk in addition to looking at business line and geographical/regional risks.

OTC derivative reforms

The ongoing OTC derivative reforms are having a significant impact on banks in the region. So far, the most challenging aspect of the OTC derivative reforms for many banks has been responding to the extra-territorial aspects of the US Dodd-Frank and European Market Infrastructure Regulation (EMIR). Major jurisdictions in the region have made significant progress in implementing their OTC derivative reforms and we expect to see more requirements come into force in the next year. A number of uncertainties remain and the end-state for OTC derivative markets in ASPAC has yet to be reached.

BANKS NEED TO RESPOND TO MULTIPLE PRESSURES

CUSTOMERS

- Fewer, more expensive products
- More transparency but less flexibility
- Offered what the regulator allows, not necessarily what they want or need

INVESTORS

- Will not put up more capital without adequate returns
- Prepared to accept lower returns if risk is correspondingly lower
- Debt coupons will need to reflect the threat of bail in

REGULATORS

- Regulatory demands increase the cost of capital
- Mistrust of banks, capital markets and shadow banking
- Emphasis on personal responsibility and improved risk governance

Source: KPMG International, January 2014

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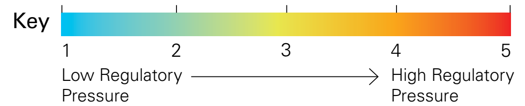
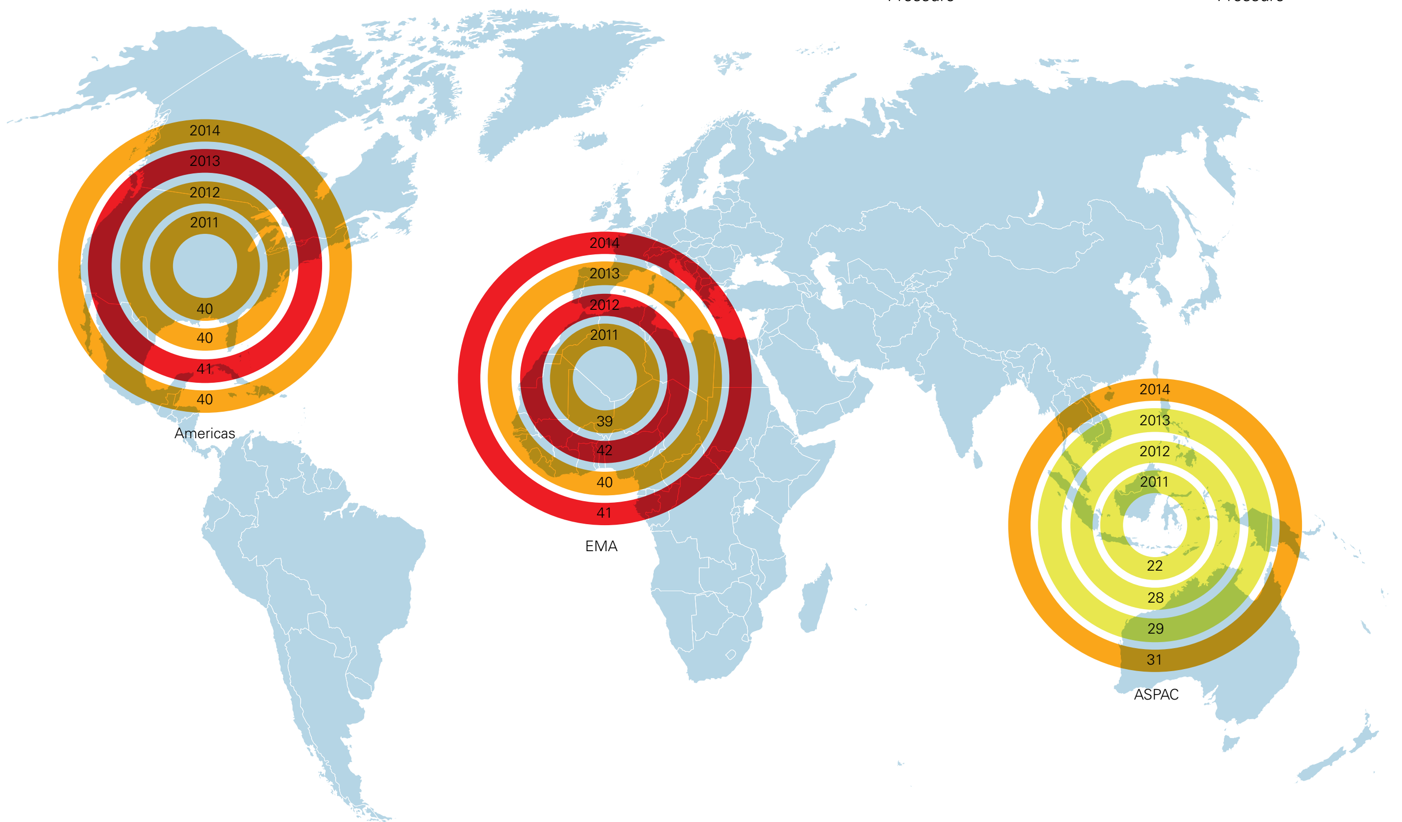
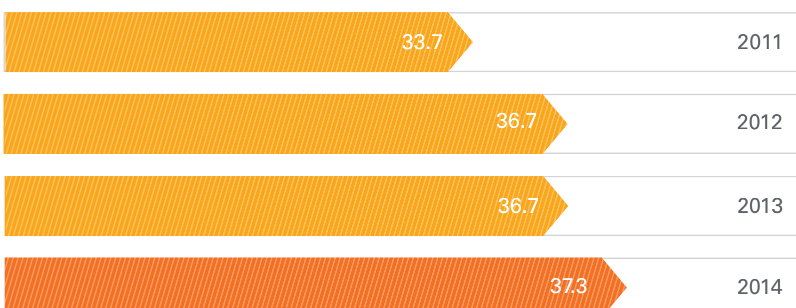
Regulatory Pressure Index

REGULATORY CHANGE – REGIONAL DIVERGENCES





THE GLOBAL PRESSURE CONTINUES TO GROW



Note: The regional numbers are the sum of the scores in each region across the ten individual areas of regulatory pressure. The global pressure index is the (unweighted) sum of the scores for each region, divided by three.

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THE EVOLVING REGULATORY AGENDA

Overall, globally, our regulatory pressure index stands slightly higher than a year ago.

Six and a half years into the financial crisis the overall regulatory pressure on banks shows little sign of abating. The implementation of the initial wave of regulatory reforms is coinciding with the continuing emergence of new regulatory initiatives, such as leverage, structural separation and localised supervision.

In some areas, pressure has eased slightly since 2013 where implementation is in progress:

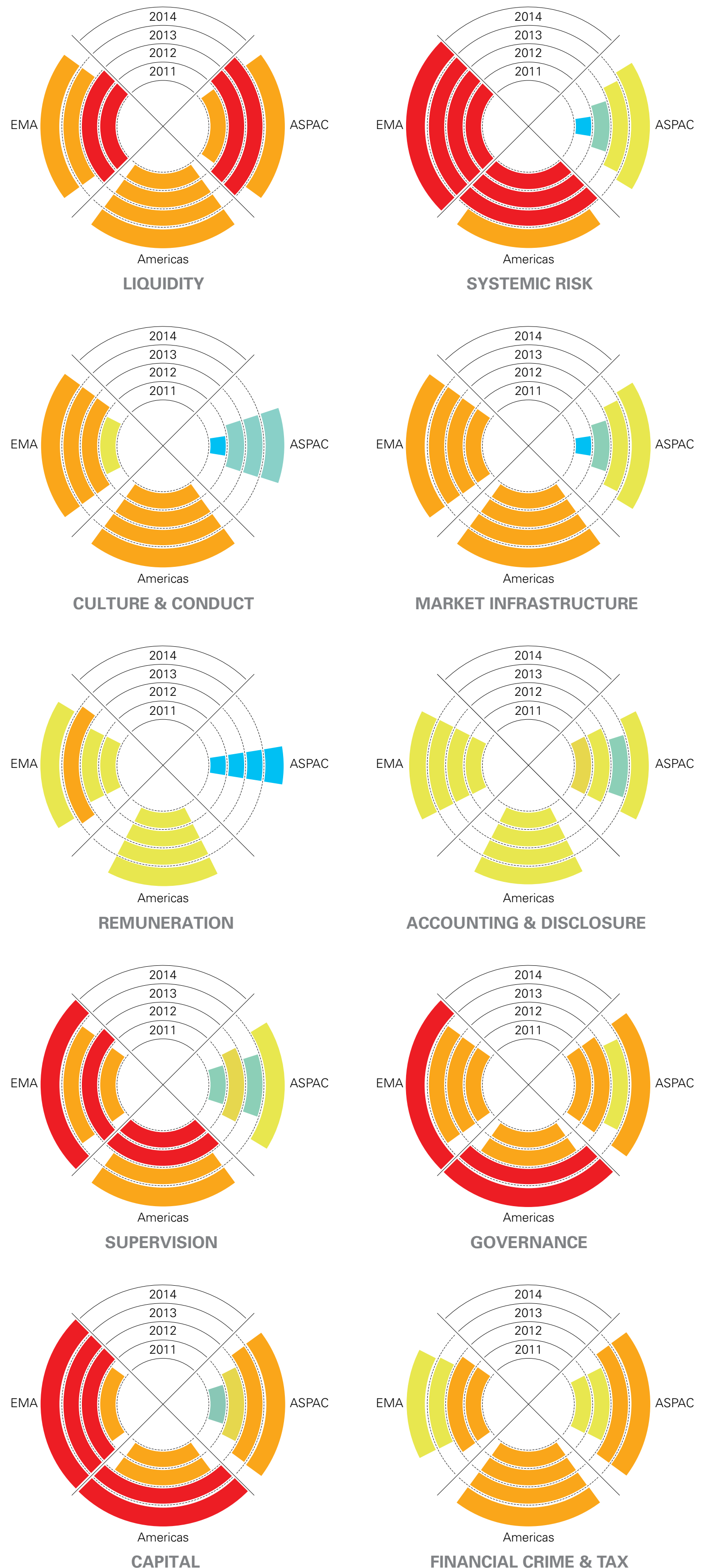
- **Liquidity** – reflecting the relaxation to the Liquidity Coverage Ratio and the balance sheet adjustments made by the banks themselves;
- **Systemic risk** – reflecting the progress made on recovery and resolution planning in the US and some other countries;
- **Remuneration** – where earlier dire predictions on banks' responses to regulatory restrictions have proved largely unfounded; and
- **Market infrastructure** – where adjustment to the requirements on the clearing, trading and reporting of derivatives is under way.

However, the flow of new regulatory initiatives has increased the pressures on banks, including:

- **Capital** – the prospect of 'Basel 4' emerging through a combination of a higher leverage ratio and a much tougher approach to the weighting of banks' credit and market risk exposures;
- **Systemic risk** – the prospect of structural separation through the various proposals emerging globally;
- **Supervision** – the increasingly intensive approach of supervisors across the globe, particularly in relation to the systemically important financial institutions (SIFIs);
- **Governance** – the series of FSB and Basel Committee initiatives on risk governance, and the wide-ranging new requirements on data reporting;
- **Culture and conduct** – where large banks in particular face heightened pressure to improve their culture and conduct.

Regionally, the clearest trend over the last four years is the steadily increasing pressure, from a low base, on banks in the ASPAC region, as regulatory requirements mount in areas such as capital, systemic risk, recovery and resolution planning, market infrastructure, and the intensity of supervision. Overall, however, the pressures still remain lower in ASPAC than in the Americas and the EMA region. ■

AREAS OF REGULATORY PRESSURE



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01 The Financial Stability Landscape

Six years after the beginning of the global financial crisis, 2013 saw no abatement in the number of new regulatory initiatives or the degree of supervisory intensity.

At a global level, the Basel Committee published a key paper on risk data aggregation and reporting, The Financial Stability Board published a series of papers on risk governance and continued to focus on systemic institutions and on progress in implementing regulatory reforms.

The regulatory reforms intended to improve the resilience of banks and markets, to make banks resolvable without recourse to public funds, and to increase the supervisory intensity on systemically important banks, have finally begun to take final shape.

Equally, however, even if the direction of travel is all too clear, the list of unfinished business remains long, casting a pall of uncertainty over the detail of the regulatory reform agenda. This is particularly true of the leverage ratio and the growing prospect of regulatory restrictions on banks' use of internal model-based approaches for the calculation of capital requirements for credit and market risks. In addition, the Basel 3 minimum capital requirements may be superseded in some national jurisdictions by stress scenario-based requirements. A significant shift to a tougher 'Basel 4' may yet emerge from the finalisation of these areas of unfinished business.

It is therefore important for banks to consider all of these moving parts, together with the elements that are already more or less firmly in place. Addressing issues in isolation will not be effective.

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OTHER BASEL 3 RELATED UNCERTAINTIES

→ Large exposures

The Basel Committee consulted in March 2013 on the measurement of, and limits on, banks' large exposures. The main proposed changes were to:

- Tighten the reporting (by moving to a 5 percent of CET1 threshold) and 'hard' limits on large exposures (leaving the upper limit at 25 percent of capital, but again narrowing the definition of capital to CET1 capital);
- Define more precisely how exposures should be measured, so the requirements can be applied more consistently across countries; and
- Impose tougher limits on the large exposures of systemically important banks.

→ Central counterparties

In a series of papers issued in June 2013, the Basel Committee, the International Organisation of Securities Commissions and the Committee on Payment and Settlement Systems outlined revised capital adequacy standards for exposures to central clearing counterparties (CCPs). They also proposed standards for counterparty credit risk (where the Basel Committee is consulting on consolidating the two existing non-modelled approaches, namely the current exposure method and standardised method), and the capital and other support required by CCPs, including for their recovery and orderly resolution.

→ Pillar 2

It remains unclear how 'Pillar 2' capital requirements will adjust as a result of the implementation of Basel 3. In principle, the tougher minimum Pillar 1 requirements should mean that banks are subject to smaller Pillar 2 capital add-ons, since there are fewer risks that are not adequately captured by the Pillar 1 minimum requirements. But on the other hand, Basel seems to be suggesting that Pillar 2 will play an increased role in the scheme of things.

→ Securitisation

The Basel Committee issued a second consultative paper on securitisation in December 2013. This proposes higher and more risk-sensitive capital requirements for securitisations, with a minimum 15 percent risk weighting; reduced 'cliff effects' in capital requirements as the quality of the underlying assets deteriorates; less mechanistic reliance on external credit ratings; and greater consistency with the treatment of credit risk more generally. Banks will be able to choose from three approaches to the calculation of capital requirements – an internal ratings-based (IRB) approach, an external ratings-based approach, and a standardised approach.

→ Modelling practices

The Basel Committee's continuing review of bank modelling practices has resulted in its expressing concerns at the extent of freedom currently possessed by banks in their modelling choices. As a consequence it is giving consideration to whether greater constraints on permissible modelling practices are required including by way of the introduction of floors and benchmark requirements.

But many uncertainties remain here, the most important of which relate to liquidity, the leverage ratio, and risk-weighted assets.

Basel 3

ASPAC jurisdictions have made significant progress in implementing key aspects of the Basel 3 reforms, particularly in the area of capital requirements.

As an example of the type of approach Asian supervisors have been taking, the new financial services authority in Indonesia, Otoritas Jasa Keuangan (OJK), which has taken over responsibility for banking supervision from Bank Indonesia, issued a regulation in December 2013, aimed at bringing minimum capital requirements into line with Basel 3. The new regulation regulates minimum capital adequacy ratio and components of capital (common equity tier 1; additional tier 1, and tier 2 capital), additional capital (capital conservation buffer, countercyclical buffer, and capital surcharge for D-SIBs), RWA calculation for market risk and operational risk, and ICAAP. There will be a transition period for the implementation of this regulation: the minimum capital requirements (8%-11% depending on the bank's risk profile) were effective from 1 January 2014, whereas the capital component requirements will become effective on 1 January 2015, the capital conservation buffer requirements gradually from 1 January 2016 up to 1 January 2019, and the countercyclical buffer and capital surcharge on 1 January 2016.

The approach taken in Malaysia by Bank Negara Malaysia (BNM) is along similar lines. The new higher capital requirements will be implemented gradually beginning from 2013 to 2015. The capital conservation buffer will be applied in Malaysia as per the Basel Committee approach, i.e. BNM adopted a gradual phase in from 2016 through to 2019, building up to +2.5% in additional CAR requirement funded entirely by CET1. BNM has not yet confirmed details of the countercyclical buffer.

But, aside from capital, many uncertainties remain, the most important of which relate to liquidity, the leverage ratio, and risk-weighted assets.

Liquidity

The Basel Committee signed off on a revised approach to the Liquidity Coverage Ratio (LCR) – the amount of high quality liquid assets that a bank should hold to cover stressed cash outflows over a 30-day period – in January 2013. This makes it easier for banks to meet the LCR than under the original proposals, by expanding the definition of high quality liquid assets to include equities, residential mortgage-backed securities and lower rated corporate securities (although not all regulators in ASPAC may allow all such

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asset types, if they are not liquid in the local market); reducing the assumed outflow rates on some types of liability; and phasing in the minimum LCR requirement from 60 percent in 2015 to 100 percent from 2019.

Work continues on the Net Stable Funding Ratio (NSFR) – essentially a requirement on a bank to hold sufficient stable deposits (retail and long-term wholesale deposits) to fund its long-term lending. Banks are required to report their NSFR positions during an observation period running until 2016, after which the NSFR is due to be finalised and to become a binding requirement from 1 January 2018. The Basel Committee relaxed the calculation of the NSFR in January 2014, and has so far resisted adopting simpler measures focused more directly on short-term wholesale funding – for example as in the proposal by US Federal Reserve Governor Tarullo that banks that are substantially dependent on wholesale funding should hold additional capital.

Enhanced liquidity risk management/ asset and liability management/interest rate risk management is seen as a priority by many ASPAC regulators. Reasons for this differ from jurisdiction to jurisdiction: in some, it may be prompted by a desire to match international standards and best practices; in others it may be to prepare the banks to better deal with market liberalisation and interest rate deregulation. A key theme everywhere, however, is enhancing institutions' resilience to liquidity stress, with a particular focus on how institutions will fare when dealing with potential fund outflows when quantitative easing is tapered.

In some jurisdictions, regulators have introduced not only the new Basel requirements but additional ancillary measures. In Hong Kong an innovative "stable funding requirement" has been introduced, requiring banks with strong lending growth to match a portion with six month-plus funding.

In Australia the issue of insufficient High Quality Liquid Assets (HQLA) has been addressed by the permissible usage of a committed liquidity facility from the central bank. This has involved establishing requirements for: appropriate balance sheet adjustments by banks prior to the establishment of the facility; the pricing of this facility in a manner consistent with the liquidity costs of an "equivalent" portfolio of HQLA; and acceptable collateral arrangements for usage of the facility.

Most ASPAC members of the Basel Committee and many other ASPAC jurisdictions have already announced – or are expected to announce – that they intend to implement the LCR and the NSFR, possibly with some modifications to reflect local circumstances.

In Singapore, the Monetary Authority of Singapore (MAS) released a consultation paper outlining the requirements related to LCR in the third quarter of 2013, and sought feedback from market participants. The requirements were set at standards higher than those prescribed by the Basel Committee, imposing 100% LCR on Singapore dollar denominated business from 1 January 2015, earlier than the timeline set by the Basel 3 requirements. All banks, merchant banks and finance companies in Singapore will have to meet the required minimum LCR levels once the requirements are finalised by MAS .

Leverage ratio

Many banks are already reporting their leverage ratios to their supervisors as part of the 'parallel run' period due to continue until January 2017. Once finalised, the minimum leverage ratio would then become a binding 'Pillar 1' requirement from January 2018. Meanwhile, banks will have to publish their leverage ratios from the date of publication of their first set of financial statements on or after 1 January 2015, using a common disclosure template and including a reconciliation statement to their published financial statements.

The Basel Committee will continue to assess the appropriateness of a 3 percent minimum leverage ratio based on total tier 1 capital, and to consider the impact of using either CET1 capital or total regulatory capital as the capital measure.

Meanwhile, the Basel Committee has relaxed somewhat the initially tough proposals it consulted on in July 2013 on how exposures will be measured. The amendments announced in January 2014 will allow some netting of securities financing transactions with the same counterparty; avoid the double-counting of derivatives cleared through central counterparties; and apply less punitive credit conversion factors to off-balance sheet exposures.

Some commentators continue to argue for a minimum leverage ratio higher than 3 percent, with some suggesting a minimum ratio of at least 6 percent. They argue that:

- If the 3 percent minimum leverage ratio is calibrated against the minimum Basel 3 risk weighted capital ratios, then it ought at least to be set proportionately higher for systemically important banks that are required to meet higher capital ratios, and to adjust in line with counter-cyclical capital requirements;
- In a world characterised by uncertainty (where it is not possible to attribute precise probabilities to outcomes), it may be better for policy makers to follow a simple rule rather than trying to match real world complexities; and
- Simple rules (using leverage ratios and market capitalisations) would have predicted better which banks ran into difficulty during the financial crisis.

A higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a 'front stop' rather than a 'back stop' requirement.

Some countries, including in ASPAC, such as China, are already moving ahead of the 3 percent minimum leverage ratio.

A higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a 'front stop' rather than a 'back stop' requirement. This could have perverse consequences. Banks could be incentivised to hold riskier assets; the capital cost of funding a portfolio of low risk-weighted assets and off-balance sheet exposures, including mortgage lending and sovereign debt, would increase; and focusing on a non risk-sensitive measure would remove an incentive (regulatory permission for a bank to use internal models to calculate risk weights) that can be used to drive improved risk management by banks.

Risk-weighted assets

Basel 3 focused mostly on the quality and quantity of capital, and the new minimum leverage and liquidity ratios, while maintaining the internal model-based approaches to credit, market and operational risk. More recently, however, the Basel Committee and other regulatory authorities have been focusing on the risk weightings generated by banks using their own internal models.

The main regulatory concerns here are that:

- Some banks have been aggressive in the use of internal model-based approaches to drive down risk weightings;
- Some banks are reducing their capital requirements through 'risk weighting optimisation', even if some of this reflects no more than cleaning up data and the planned rolling out of risk modelling to a broader set of exposures;
- Risk weightings generated by internal models are too complex and opaque;
- A prolonged period of low interest rates is enabling borrowers to avoid default, and thereby generating misleadingly low probability of default estimates; and
- There is limited transparency – and therefore limited scope for relying on market discipline – in this area.

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TOUGHER TRADING BOOK REGIME MOVES CLOSER

The Basel Committee has published two consultative documents on a fundamental review of the trading book, in May 2012 and October 2013. The most recent paper narrowed down the range of options to a single set of proposals which will form the basis for a Quantitative Impact Study. The main proposals cover:

- A simpler and tougher boundary between the trading book and the banking book;
- Calibrating both internal models-based approaches and the standardised approach for market risk against stressed market conditions, and changing the basis of calculation from value at risk (VaR) to Expected Shortfall (ES) measures. This will increase capital charges under both approaches;
- Extending the assumed time horizons for liquidating exposures in stressed market conditions;
- A tougher approach to allowing benefits from hedging, based on whether a hedge is likely to be effective during periods of market stress;
- Restricting the calculation of capital charges for credit risk on securitisations in the trading book to the revised standardised approach; and
- Requiring banks using internal models to disclose both their internal models-based capital charges (disaggregated by type of capital charge and by trading desk) and the capital charges that would have been required under the standardised approach.

→ The Basel Committee is still considering whether to restrict the benefits of internal models-based approaches in the trading book, for example by applying a floor or a surcharge to limit the extent to which model-based approaches can deliver lower regulatory requirements than under the standardised approach.

The overall effect of these proposals, if implemented, would be to reduce significantly the benefit available to banks through the use of internal models, and increase banks' costs as a result of both restrictions on capital benefits and increased operational costs. The proposals will also increase the capital required under the standardised approach.

These reduced benefits and increased costs will drive banks to reassess the pricing and continuation of product lines, with implications for banks' customers. More generally, together with regulatory requirements for the central clearing of derivatives and market and regulatory driven increases in collateral, these proposals will fundamentally change the dynamics and economics of trading.

A series of Basel Committee and European Banking Authority (EBA) reports during 2013 on the risk weightings of banks' banking book and trading book assets have revealed wide divergences in risk weights. Underlying differences in the risk composition of banks' assets are found to explain between half and three-quarters of the variations in risk weightings across banks for banking book assets, but only half of the variation for trading book assets. The remaining variation is driven by two main factors – diversity in the models used by banks, and diversity in supervisory guidelines and practices.

In response to these findings, the Basel Committee has already formulated proposals to restrict the extent to which model-based approaches can reduce the capital required against market risk (see box overpage) and to increase consistency across banks. Similar proposals can be expected on internal-based model approaches to credit risk, including:

- Limiting the flexibility of the advanced approaches, for example by setting 'benchmarks' for risk parameters (which supervisors could use as a reference point for assessing firms' internal model estimates), or setting more explicit constraints such as floors (or even fixed values) for certain parameters. This would limit the extent to which a bank could benefit from using model-based calculations of capital requirements;
- The imposition of minimum parameters to reflect stressed conditions;
- Additional policy guidance to constrain differences in bank and supervisory practices; and
- Enhanced Pillar 3 public disclosures by banks to improve understanding of how banks calculate risk weighted exposures using internal models.

It is too soon to say how Basel, or ASPAC regulators, will address these concerns. An early mover on this has been the Hong Kong Monetary Authority (HKMA). As a first step, the HKMA mandated that banks using the IRB approach should adopt a minimum risk weight of 15% for all new residential mortgage loans. This was followed, as a second step, by the reintroduction of "floors" for IRB risk-weighted assets relative to standardised approach. It will be interesting to see whether Basel itself, or other individual regulators, adopt a similar conservative approach.

We have also seen, in a complementary move, regulators making greater use of macro-prudential policy tools in relation to property exposure. For example, following extensive oversight and thematic reviews/ data collection, the Reserve Bank of New Zealand (RBNZ) implemented a restriction on the level of new high Loan-to-Valuation residential mortgage lending towards the end of 2013 in an attempt to counter house price inflation in New Zealand and mitigate the potential risks to the wider financial system. This was imposed via a banking license condition of registration across all banking institutions and necessary process, policy, pricing and system changes are being put in place to ensure banks are able to adhere to this new condition and accurately record and report the necessary information to the RBNZ.

The Basel Committee has already formulated proposals to restrict the extent to which model-based approaches can reduce the capital required against market risk.

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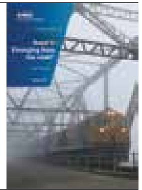
For more information on Basel 4

Basel 4 – Emerging from the mist?
http://www.kpmg.com/global/en/issuesandinsights/articlespublications/regulatory-challenges/pages/emerging-from-the-mist.aspx



'Basel 4'

'KPMG has argued that a 'Basel 4' may already be emerging, even before Basel 3 is fully implemented. Key elements of this may include:

- A higher leverage ratio, and higher risk-weighted assets, as discussed above;
- The gold-plated implementation of Basel 3 in some countries, including the US and the UK and several in ASPAC such as Hong Kong and Singapore; and
- Requiring banks to meet minimum capital ratios after the potential impact of severe stress events, and therefore to hold significant additional capital buffers, contrary to the intention in Basel 3 that the capital conservation buffer and any counter-cyclical capital buffer would be the cushion to absorb a shock.

In a related development, the Basel Committee published in July 2013 a discussion paper on balancing risk sensitivity, simplicity and comparability. This noted both the advantages of greater simplicity and comparability, and the potential disadvantages of overly simplistic capital requirements. The paper also set out some ideas to improve simplicity and comparability:

- Recognising simplicity as an additional objective against which new Basel Committee proposals should be judged;
- Mitigating the consequences of complexity in model-based approaches by adding floors to constrain the results of modelled capital requirements; introducing a more refined 'use test'; and limiting national discretions in the area of internal models;
- Strengthening the leverage ratio by replicating elements of the risk-based capital requirements – adding 'buffers' to the leverage ratio and imposing tougher leverage requirements on systemically important banks;
- Enhancing disclosure by requiring banks to disclose the results of applying their models to hypothetical portfolios; to disclose both modelled and standardised calculations; and to publish additional metrics that might be useful to investors, such as capital ratios using market values of equity, risk measures based on equity volatility, revenue-based leverage ratios, historical profit volatility, and the ratio of non-performing assets to total assets; and
- More fundamental longer-term reforms such as relying on a tangible equity leverage ratio; abandoning the use of internal models; imposing capital requirements against income volatility; or reducing risk and complexity by limiting the use of complex and innovative financial instruments and restricting non-traditional banking business.

Reflecting these themes, the paper also discussed a re-balancing of the three pillars to place more emphasis on Pillar 2 and Pillar 3. Pillar 1 minimum requirements could then be simplified, while shifting some of the complexity – including internal modelling approaches – into Pillar 2, and while enabling shareholders, bondholders and market analysts to exercise a more informed view based on enhanced disclosures by banks.

EMERGENCE OF BASEL 4

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Recovery and resolution

The legislation and regulatory guidance necessary to underpin recovery and resolution planning has been strengthened considerably over the last year. The FSB's 'Key Attributes for Effective Resolution', published in November 2011, provided a sound basis for the development of national regimes, while the FSB's Guidance papers on recovery and resolution planning (July 2013) form the basis for more detailed planning for the recovery or resolution of a major international bank.

In ASPAC we have seen several regulators starting to require both the major local banks and the local operations of global banks to prepare a local recovery plan (generally the focus to date has been on the recovery element rather than on resolution).

Practices differ on which institutions are required to prepare an RRP. Many regulators are suggesting that this will be limited to G-SIFIs and D-SIFIs, but others (such as the HKMA) are proposing to apply the requirement more broadly, to all institutions.

Although Australian banks came through the global financial crisis relatively unscathed, the Australian Prudential Regulation Authority (APRA), in conjunction with other authorities in the Australian Council of Financial Regulators (COFR), undertook a number of measures to strengthen the capacity to resolve banks in difficulty should that event ever arise. The initiatives included the enactment of new statutory resolution powers, the introduction of a deposit guarantee scheme, the implementation of a framework for domestic coordination of resolution within the COFR agencies and crisis resolution testing by the COFR. A framework was also entered into between the Australian and New Zealand authorities to coordinate cross-border crisis resolution involving banks with a systemic presence in both countries. APRA has also introduced recovery planning requirements for large and second tier banks, and has signalled the intention to broaden this to insurance. However, at this stage, APRA has not released any proposals for institution-specific resolution planning. The only resolution planning under way is the pre-positioning requirements for the deposit guarantee scheme, including requiring Authorised Deposit-taking institutions (ADIs) to have the capacity to aggregate protected deposits on a Single Customer View basis. It remains to be seen whether and to what extent APRA may extend resolution planning to other aspects of resolution, particularly for D-SIBs.

In addition, APRA, in coordination with the Reserve Bank of Australia, has strengthened its stress testing framework for the Australian banking system. Stress testing was undertaken in 2012 for the IMF FSAP of Australia and APRA has subsequently increased its resourcing in this area. In the context of its ongoing risk-based supervision, and as part of the new risk management prudential requirements applicable to ADIs and their groups, APRA is likely to place greater emphasis on the stress testing capability of banks and the integration of stress testing into their risk management and risk appetite frameworks.

Meanwhile, globally, the bail-in tool – which passes the cost of meeting losses and of recapitalising a failing bank on to creditors by writing down the value of their claims or converting them into equity – has been gaining momentum.

ASPAC regulators are watching closely how the "single/multiple point of entry" debate plays out.

Some national resolution authorities – in particular those in Switzerland, the UK and the US – are expecting most international banking groups to follow a 'single point of entry' approach.

This would require loss-absorbing capacity to be issued at parent (holding company) level, and then down-streamed to the operating subsidiaries of the group, so that in a resolution the conversion or writing-down of this capacity could both recapitalise the group and enable it to meet losses in operating subsidiaries. This would also buy time for the authorities during the initial stages of a resolution, making it less necessary to make immediate use of other resolution tools that would break up or sell off the business of the group. Instead, a recapitalised group could be preserved, albeit under new ownership and new management.

However, it remains unclear how the cross-border resolution of a major international banking group would operate in practice. Host national authorities may seek to maximise the capital and bail-inable debt available to them locally, which could turn a single point of entry approach into multiple points of entry.

For investors, one key aspect of the bail-in proposals has been the need for greater certainty in how the bail-in tool will be used in practice. This includes the conditions under which the resolution trigger will be activated (the point of non-viability of a bank); the choice of resolution tools by a national authority; the order in which different types of eligible liability would be bailed in; the choice of a national authority between writing down the value of liabilities and converting them into equity; and the extent to which a national authority might make use of a resolution fund or even government support as an alternative to the bailing-in of liabilities.

The single point of entry approach also raises a question as to whether the home authority would be willing to impose losses on parent bank creditors to recapitalise foreign subsidiaries without a contribution from the host countries in question – e.g. a subsidy from the host taxpayers to reduce the extent of loss imposed on parent bank creditors to cover losses in the foreign subsidiaries or some other form of burden sharing between home and host countries. ■

The bail-in tool – which passes the cost of meeting losses and of recapitalising a failing bank on to creditors by writing down the value of their claims or converting them into equity – has been gaining momentum.

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'The most rigid structures, the most impervious to change, will collapse first.'
Eckart Tolle

02 Structure

Banks face multiple pressures to reconsider their strategies, business models and operating structures. These range from structural separation requirements to bail-in liabilities, and from capital requirements to liquidity.

For customers of banks the impact of these changes is marked – banking products and services are becoming more expensive, and in some cases the availability of products and services may be constrained.

Many structural changes are already under way, including significant deleveraging by many global banks as they strive to improve their capital and liquidity ratios. Other changes are being assessed by banks, and may follow as the detail of unfinished regulatory requirements becomes clearer, and as the cumulative impact of regulatory reforms becomes fully apparent.

In wholesale markets the end result is already beginning to emerge, with a small number of 'scale' players becoming even more dominant. In retail markets the end game is less clear, but may involve regulatory protection for local players, operating in less competitive markets.

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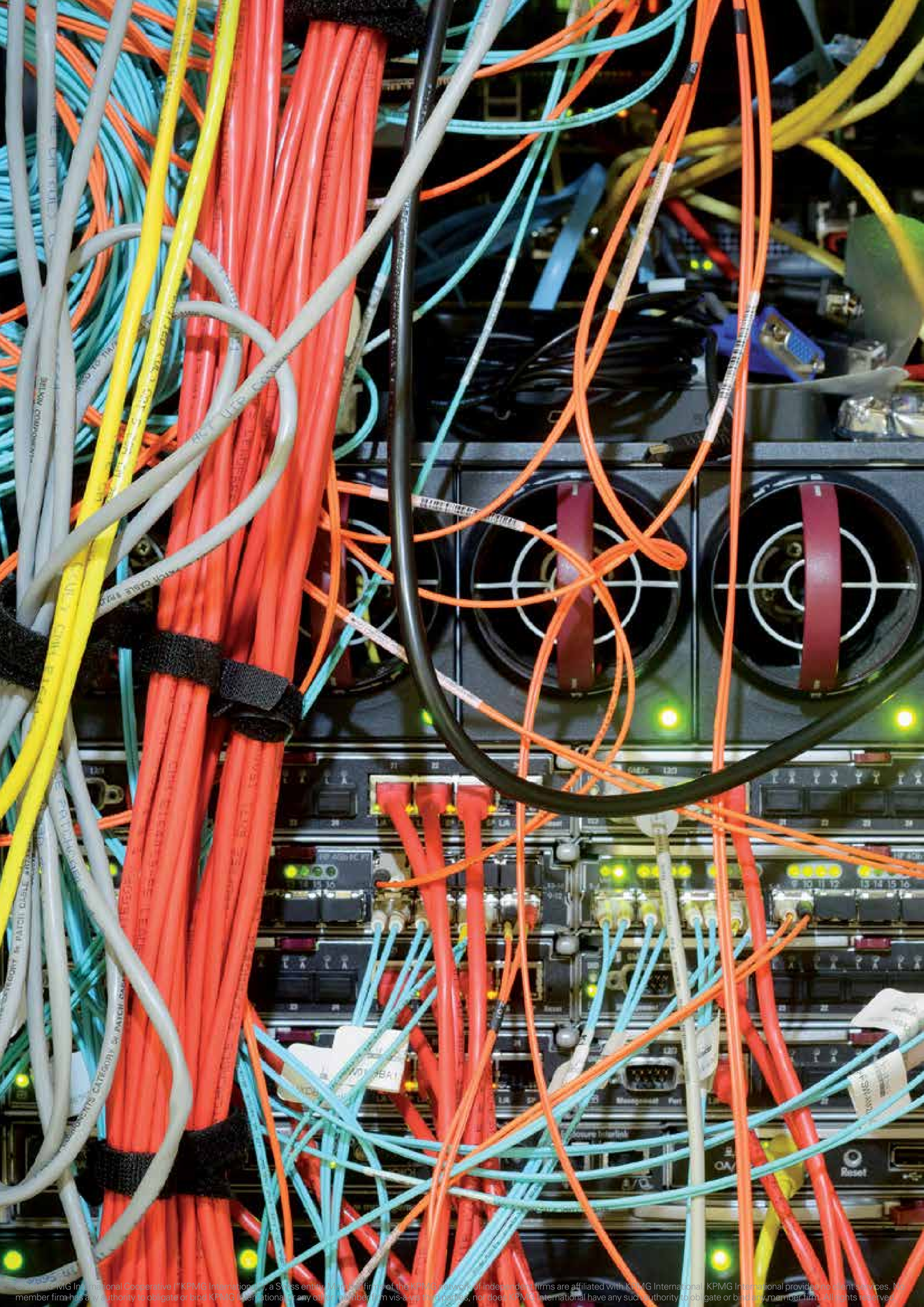

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It is not entirely clear what value structural separation brings in addition to higher capital requirements, recovery and resolution planning, and the more intensive supervision of systemically important banks.

Regulation

Regulatory initiatives are driving banks' decisions on structure through three main routes – direct legislative or regulatory requirements for structural separation; the indirect impact of capital and liquidity requirements; and localisation.

Structural separation

The most direct regulatory pressure on structure is through the rules being introduced on structural separation – most notably for Europe with the Commission proposals published in January 2014. Some countries – including the UK, France, Germany and Belgium – are developing, or have already introduced, legislative requirements for structural separation between differing types of retail and investment banking activities, while in countries such as the Netherlands and Belgium a succession of failures as a result of the financial crisis has already led to the break-up of universal global banks.

The driving forces behind all these legislative initiatives have been to reduce the size and complexity of previously 'too big to fail' banking groups; to limit the extent to which insured retail deposits can be used to support investment banking activities; and to enable retail banking operations to be more easily carved out and transferred or supported in the event of a large banking group running into difficulty. Cultural change has been added to this list – driven by the revelations in Europe on the fixing of LIBOR and foreign exchange benchmarks.

Structural separation requirements are in effect a sub-set of resolution planning, since they place specific critical economic functions in an operational, institutional and governance structure that would make it easier to continue these critical functions within the resolution of a failing banking group. Other critical economic functions may be similarly identified and structured in due course, albeit through less severe forms of ring-fencing.

Regulatory restrictions are also being introduced to improve the resilience of markets rather than of individual banks. These include the mandatory central clearing of derivative instruments; introduction of initial as well as variation margins requirements on OTC contracts; reporting requirements on derivative transactions; and restrictions on central clearing counterparties and their members.

However, it is not entirely clear what value structural separation brings in addition to higher capital requirements, recovery and resolution planning, and the more intensive supervision of systemically important banks.

Structural separation does not prevent ring-fenced retail banks taking on risk through the asset side of their balance sheets, while on the other side of the fence trading entities can be systemically important and therefore cannot be simply ignored. And creating separate entities within a single banking group cannot entirely eliminate spill over effects.

Perhaps this is why we have not seen similar initiatives being undertaken by regulators in ASPAC, whose focus has been more on ensuring adequate controls over each area of business than on structural separation, and in seeking to understand how volatility in trading businesses could impact on the banking business (from both a financial and reputational point of view).

In Australia, additional prudential requirements for conglomerate financial groups have been proposed as from 2015. These will be applied to a limited number of groups and do not impose restrictions on permissible activities, including by separation. They do require the calculation and holding of sufficient CET1 capital to support the risks of the entire group including material risks arising from non-APRA regulated institutions. In addition the "Level 3 group" must have: a robust governance framework that is applied throughout the group; transparent and prudent management of intra-group and aggregate external exposures; and an effective group-wide risk management framework, the minimum requirements for which have been the subject of extensive revision.

Malaysia is another jurisdiction which has applied prudential requirements at the Financial Holdings level.

Capital, funding and liquidity requirements

Although there are wide differences in view on the cost of imposing tougher capital, funding and liquidity requirements on banks, the overall impact of regulatory reform initiatives in this area has been – and will continue to be – substantial. As discussed in Chapter 1, these initiatives include not only Basel 3 itself, but also the capital surcharges, resolution planning requirements and more intensive supervision of (at least) systemically important banks; requirements to hold bail-inable debt; the likely outcomes on the leverage ratio, risk-weighted assets and stress testing.

In Australia, its four largest banks have been identified as D-SIBs and will be the subject of a higher loss absorbency capital requirement. This will commence without transition in 2016 and comprise a 1 per cent extension of capital conservation buffer requirements including its restriction to being only CET1 capital. APRA introduced its Basel 3 minimum capital requirements in full as from the start of 2013. It did so without adopting permissible regulatory adjustments to capital deductions or the transitional phase-in for these deductions. This reflected the ability of Australian banks to fully meet these requirements as from 2013.

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These regulatory reforms are shaping banks' business models and pricing, with new minimum capital, leverage, loss absorbency and liquidity requirements and new asset class risk weightings determining the liability structure and the minimum returns required to meet the cost of capital and other funding. This also reduces the flexibility of banks to determine which clients, products and markets they engage with.

In addition, as discussed in Chapters 3–5, higher regulatory costs are also being imposed through a host of other regulatory requirements, ranging from retail and wholesale market conduct requirements to reporting and risk governance. These costs have to be borne by shareholders, customers and market end-users.

Localisation of finance

Host country authorities, such as in ASPAC, are focusing more on preventing the failure of the local operations of foreign banks where they are of systemic importance for the local system, on maintaining critical local economic functions in the event of failure, and on protecting local creditors and taxpayers in the event of the failure of a foreign bank. Host country authorities are therefore increasingly requiring foreign banks to operate within the host country as subsidiaries rather than branches; to meet local standards – on capital, liquidity, stress-testing, bail-in liabilities and governance and risk management (either as subsidiaries or as 'synthetic branches'); and to limit their intra-group exposures and their reliance on shared services.

Increasingly, foreign subsidiaries are being expected by the host regulators to be "real" subsidiaries, rather than de facto branches, with Boards comprising a number of independent directors and, in some cases, a prohibition on the Board of the subsidiary complying with directives from the parent where compliance could be injurious to the position of the subsidiary.

Meanwhile, moves to introduce greater structural separation, home country recovery and resolution planning, and a 'single point of entry' approach to the use of the bail-in tool has reduced the confidence of some host country authorities that the local operations of foreign banks will receive support from the home country authorities in the event of difficulties arising in an international banking group. Host country authorities are becoming increasingly unwilling to rely on the capital, liquidity, funding and regulatory oversight of the parent bank.

International banking groups face difficulties in accommodating so many national regulators, often with a lack of commonality of objectives and trust between the home and host supervisors. These groups want to be global in terms of products, services and customers, and have generally adopted business, operating and governance and risk models that are consistent with this vision. They are trying to adapt and substantially preserve this vision given its competitive and other advantages, while accepting that an undiluted global view is no longer viable after the financial crisis.

For international banking groups, the main cost of greater localisation is a declining ability to manage capital, liquidity, funding and bail-in liabilities at a group level. Holding 'trapped' resources in each relevant jurisdiction pushes up the cost of doing business, with an impact on the cost of products and services to customers. Similarly, booking transactions in multiple locations reduces the advantages of netting, the efficient use of collateral, and the efficient use of capital.

Moreover, having large exposures measured relative to local capital rather than group capital can impair the ability to service the largest customers and counterparties.

Host country authorities are becoming increasingly unwilling to rely on the capital, liquidity, funding and regulatory oversight of the parent bank.

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What are banks doing?

Regulatory drivers do not operate in a vacuum. Macro-economic developments, market competition and technological advances are also key factors. And banks are keen to control their own destiny, determine their own commercial strategy, or at least to preserve a high degree of optionality as regulatory requirements evolve. But whatever the drivers, some key themes can be identified in how banks are responding to regulatory and other pressures.

Legal entity re-structuring

Banks subject to national requirements to ring-fence specific activities are already planning to implement the necessary changes. More generally, the proposed European Union (EU) legislation on structural separation and the emphasis on resolution planning by home authorities and host authorities, such as in ASPAC, are leading banks to consider their operating and legal entity structures. Many banks are taking a cautious approach here, waiting to see how regulatory expectations evolve – not least because in many jurisdictions the authorities are yet to reach any conclusions on how (if at all) banks should restructure in order to make resolution a credible option.

Banks need to create a viable business model with:
- **a legal entity structure that would enable the resolution authorities to apply their resolution tools and powers effectively to regulated entities within their jurisdictions;**
- **a financial model that can support the costs of the new liability requirements (capital and additional loss absorbing capacity) where it is needed at different points in the legal entity structure; and**
- **an operating model that delivers both efficiency and operational continuity of internal and external suppliers in support of critical functions.**

Banks also need to consider how to reflect the cost of recovery optionality and resolution flexibility in their pricing.

Some banks are pressing ahead with restructuring, in particular where the necessary changes to their business models in response to the financial crisis and regulatory expectations are clear. There is no single model here, but the general shape of restructuring has focused on moves towards:
- A top level holding company (in part to meet regulatory pressures for a 'single point of entry' approach to bail-in debt);
- Operating subsidiaries that reflect a closer alignment between business activities and legal entities, based on a simplification and rationalisation of legal entities;
- Meeting local regulatory requirements for capital, liquidity, recovery and resolution, governance and risk management capabilities;
- Implementing clearer and better understood governance, control and accountability structures within the key operating entities;
- A more regional 'hub' structure and approach to running businesses and managing risk, including to booking trades and transactions – although it remains unclear whether this will be a stable end-point in either commercial or regulatory terms;
- Either a decentralisation of services to individual entities with the group, or the creation of a 'resolution-proof' shared service provider structured as a separate entity within the group; and
- Simplifying and netting down trades with major counterparties.

Focus on core activities

Many banks have been re-evaluating where they want to remain active, in terms of markets, geographies and customer segments.

Banks need to consider which business activities can succeed in the new financial and regulatory environment, and which activities are 'non-core' or 'marginal' as a result.

In some cases this choice has been exercised by the authorities, as a condition of banks receiving some form of state aid, with banks being forced to sell, transfer or withdraw from various types of business.

In other cases this has been a commercial decision, driven by a variety of factors such as profitability and the volatility of profits; the balance between risk and reward; customers and markets; the efficient use of capital, liquidity, funding and leverage; competitive advantages and the comparative advantages of the bank's people, systems and IT infrastructure; complexity; the degree of understanding of the business; and operational risk, regulatory risk and taxation.

Retail and corporate banks have generally pulled back most sharply from international business activities, including sales of overseas business units and a sharp reduction in overseas lending by many banks.

Investment banks have in many cases withdrawn from specific business lines (for example some segments of fixed income and commodities trading) while seeking to maintain a scale presence in whichever business lines they consider to be 'core' activities.

Overall, this has resulted in:
- Many banks becoming less diversified in terms of business activities and more concentrated in a single country or region;
- Some universal (retail and wholesale, or some combination of banking, insurance and asset management) banks considering whether they can remain universal – and indeed their hand may be forced by the proposed European legislation on structural separation;
- A smaller number of large-scale players in each wholesale market;
- Potential for the remaining players in each market to make higher returns;
- A more pronounced bifurcation in the distribution of banks in each market and location, between a (smaller) number of large players and a large number of smaller players – although more mid-size players may emerge from consolidation among the smaller players; and
- Greater scope for the emergence of local and regional players, for example in ASPAC, India and South America, which may be reinforced by the increasing importance of South-South trade and finance.

Balance sheet size and structure

A combination of regulatory and market pressures is forcing banks to assess their capital and liquidity positions against the 'fully loaded' (not transitional) minimum Basel 3 requirements. The latest Basel Committee and EBA analyses (using end-2012 data) of how banks are measuring up against these requirements show continued progress towards meeting capital requirements, and the favourable impact of the Basel Committee revisions to the LCR in taking many banks to above a 100 percent LCR.

There is a growing contrast between the focus of many European banks on capital, leverage, liquidity, funding and regulation more generally, and the focus of an increasing number of US banks on growth, the recovery of net income and profitability. This difference is reflected in these banks' operations in ASPAC.

Capital – many banks globally have struggled to strengthen their capital. Most have had to rely more on retained earnings than new capital issues, although the flow of retained earnings has been constrained by stagnant net income and low profitability. Low returns on equity, in some cases below the cost of capital, have not provided attractive conditions for new capital issues, although some large banks have managed to raise new capital.

Risk-weighted assets – overall, banks globally have reduced significantly their risk-weighted assets, through a combination of (a) no balance sheet growth; (b) shifts in the composition of total assets, away from non-domestic lending and from consumer credit and corporate lending, and into increased holdings of government bonds and modestly

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higher retail mortgage lending; and (c) sharp reductions in trading book activities at many banks with substantial trading books. These trends seem set to continue, with some major banks having announced plans for further significant reductions in their on- and off-balance sheet assets. Banks are getting smaller to become less risky, more capital efficient and more profitable on both an accounting and a risk adjusted basis.

Part of the explanation of these balance sheet shifts may lie with the weakness of the economy in most European countries, and hence lower demand for borrowing by corporates and less willingness of banks to lend to customers perceived to be risky. But a significant part is the result of the pressures on banks to meet capital and liquidity ratios.

In ASPAC the situation is quite different, with strong bank lending and consequent increase in balance sheet size in many jurisdictions on the back of continued economic growth.

Capital and leverage ratios – the reduction in risk-weighted assets has been the primary contributor to a pronounced improvement in capital ratios across many global banks, while modest increases in equity combined with flat balance sheets and reductions on trading books have resulted in some improvement in leverage ratios.

Funding – in addition to the modest increase in capital, other shifts on the funding side have included a marked reduction in short-term wholesale funding, a build-up of customer deposits, and debt issuance. However, this overall picture masks differences across countries.

Cost reduction

Banks are seeking to reduce their costs, not least in an attempt to offset the cumulative impact of regulatory reforms on the costs of funding, compliance, reporting, risk management and governance. This is becoming more critical in an environment of lower returns, especially in investment banking.

Many large investment banks have already announced cost reduction plans, or at least strategic reviews, where a key issue will be to reduce their cost: income ratios from the bloated levels they reached in many banks. More benign economic conditions in 2014 may facilitate an improvement in the cost:income ratio, through both higher income levels and opportunities for asset and business unit sales.

Many sources of cost reduction are being explored, including:

- Greater efficiency of processes and data management, through investment in IT systems;
- Closing branches and relying more on centralised and increasingly automated and industrialised front to back office processes;
- Focusing more on the overall profitability of products and services, and on where a bank has a competitive advantage;
- Simplifying products and services, and taking a more risk-adjusted approach to costs and revenues;
- Greater automation of some controls, including compliance and internal audit, based on a re-assessment of risk tolerance in these areas;
- Simplifying legal entity and operating structures;

Regulatory and market pressures are forcing banks to assess their capital and liquidity positions against the 'fully loaded' (not transitional) minimum Basel 3 requirements.

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- Reducing staff numbers;
- Reducing variable remuneration, on the basis of weak economic conditions and regulatory constraints on remuneration; and
- Off-shoring and near-shoring of back-office functions.

Impact on customers

At a micro level, customers of banks are being faced with a higher price and reduced availability of banking products and services. In retail banking this has fed through in terms of higher margins on lending, while in wholesale markets the shift to fewer providers of each product has resulted in both higher prices and reduced choice for customers. Meanwhile, some customers are being cut off from products and services (irrespective of price) on the basis that the risk to the bank is too great – be it prudential, conduct or wider reputational risk.

These price and supply decisions reflect both the costs of tougher regulation and banks adopting a more risk-based approach to pricing and markets, with capital and funding costs and other risk factors being allocated to individual profit centres and individual business lines.

International corporates want banks that can facilitate trade finance, make payments, provide credit, book trades and provide risk management services on a global basis, in support of global trade and investment. But the trend toward the localisation of finance is making this more difficult and expensive to provide.

Moreover, the cumulative impact of regulation, particularly in Europe, may have gone past the 'tipping point' to a situation where the costs of regulation exceed the benefits. These costs have to be paid, and to a large extent it will inevitably be the customers of, and investors in, banks who pay these costs through higher prices and lower returns. The much greater reliance on bank financing in Europe than in the US accentuates this impact on customers and investors. ■

The cumulative impact of regulation, particularly in Europe, may have gone past the 'tipping point' to a situation where the costs of regulation exceed the benefits.

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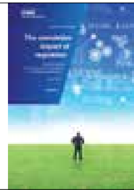
KPMG in the Netherlands – The cumulative impact of regulation
http://www.kpmg.com/NL/en/Issues-And-Insights/ArticlesPublications/Documents/PDF/Banking-and-Leasing/The-cumulative-impact-of-regulation.pdf

KPMG in Belgium The cumulative impact of regulation
http://www.kpmg.com/BE/en/IssuesAndInsights/ArticlesPublications/Documents/The-impact-of-regulation-revised.pdf



Moving on
http://www.kpmg.com/global/en/issuesandinsights/articlespublications/better-regulation-in-banking

THE CUMULATIVE IMPACT OF REGULATION

Detailed analysis by KPMG member firms in the Netherlands and Belgium has provided a bank and customer perspective on the cumulative impact of regulation. Although this analysis relates to European banks, it nonetheless has relevance for banking generally, including in the ASPAC region. This work involved four key stages:

- Qualitative discussions with local banks about which regulations were likely to have the greatest impact on banks' financial position, business model, operating model and change capacity;
- Identifying from this qualitative analysis the four most significant regulations – CRR/Basel 3, Financial Transactions Tax, bail-in debt and the pre-funding of deposit guarantee schemes;
- Quantitative analysis of the impact of these four regulations on banks' capital, leverage and liquidity regulatory ratios, and the impact on net income, profitability and cost:income ratios in the absence of any actions by the banks; and
- Assessing the extent to which banks could mitigate the impact of these regulations by taking management actions, such as reducing costs, repricing loans, issuing new capital, retaining profits by not paying dividends, changing the structure of assets (holding more high quality liquid assets) and liabilities (raising long-term wholesale funding), and reducing the size of the balance sheet.

Three core findings emerged from this analysis.

→ In the absence of any management actions, many banks would fail to meet minimum regulatory requirements and would see their return on equity fall below 8 percent.

→ A radical set of management actions would be required to enable the banks both to meet all the minimum regulatory requirements and to achieve an 8 percent return on equity. This could not be achieved by cost reductions alone, but would require a combination of actions. In the central scenario this would require:

- A 9 percent reduction in the size of the balance sheet;
- An increase in the price of loans by 80–90 basis points;
- No payment of dividends;
- A 5 percent reduction in costs; and
- Replacing the equivalent of 2.5 percent of total liabilities with long-term wholesale funding.

→ Such a set of management actions would have significant implications for customers of the banks and for the financing of the wider economy, in particular though less and more expensive credit and the provision of fewer risk management products and services.

Impact of regulation on the wider economy

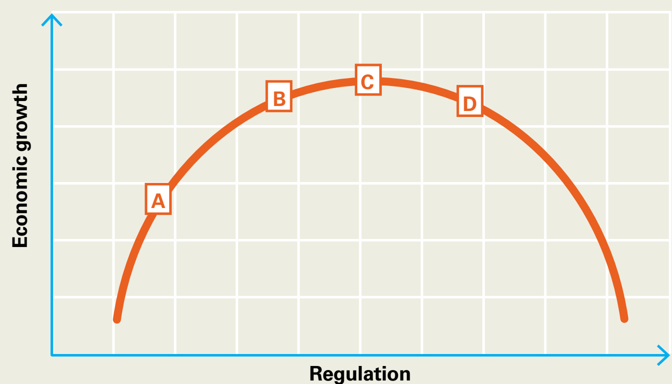
As KPMG has argued elsewhere, the relentless introduction of more and more regulation may already have taken many economies, especially in Europe, beyond the 'tipping point' to a position where the costs of regulation exceed the benefits – in terms of the permanent downward drag on economic growth exceeding the benefit of avoiding future periods of financial instability.

The relationship between regulation and economic growth may be illustrated by a simple chart, plotting these two variables. Up to a point, regulation promotes economic growth, because the negative impact of regulation on economic growth in normal times is more than offset by avoiding the severe costs of financial crises. But there is an inflexion point beyond which the negative impact of regulation on economic growth in normal times begins to exceed the benefits of regulation.

The really difficult question is establishing where the 'tipping point' lies, There is general agreement that before the financial crisis we were at point A, where too little regulation contributed to the costs of financial crises on economic growth. Official estimates of the Basel 3 capital and liquidity reforms moved regulation up to point B, leaving scope for additional regulatory reforms before reaching the 'optimal' point C. However, the evidence in Europe in particular suggests that we have moved beyond point C to point D, where excessive regulation is so damaging to the wider economy that the net impact of regulation on economic growth has become negative.

Where is ASPAC? Point B? Or perhaps Point C, with a danger of reaching Point D?

Regulation versus economic growth



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'Integrity has no need of rules.'
Albert Camus

03 Conduct, Markets and Culture

A series of conduct failings in both retail and wholesale markets globally have emerged in the last few years. This will intensify the introduction of international and national regulatory initiatives in the conduct area.

For customers the end result in both retail and wholesale markets is likely to be very similar to the impact of prudential requirements – more expensive products and more restricted choice.

The 'product push' approach to banking – focused on the desire to sell, rather than a more thoughtful view of what would best suit the needs of the customer – has led in retail banking to the various mis-selling disasters of recent years and in wholesale markets to significant and widespread market conduct issues.

Most banks are looking to become more customer centric, and have begun to make some progress in addressing cultural and behavioural issues – but this journey is far from complete. Significant change in the culture and values of many banks is required to meet the needs of customers and regulators.

Some retail banks are already focusing on the prospective shift to a more 'product life-cycle' approach to regulation, and considering the implications of this for product design and development, customer treatment and channels of distribution.

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In many respects these failings may prove to be as important to banks and their regulation as the initial financial crisis. They have been a reputational catastrophe for both the banks involved and the wider banking sector.

Conduct failings

In addition to earlier large-scale mis-selling episodes that have now moved into a remediation stage, other cases of actual or suspected mis-selling to retail customers have emerged across a wide range of countries, globally.

Meanwhile, in wholesale markets a number of major international banking groups have been fined for their involvement in the rigging of LIBOR (and other interest rate benchmarks), and for colluding in doing so, and criminal proceedings have begun against some individual traders. Regulators and other authorities are also investigating a possible conspiracy to shift foreign exchange market prices, and possible market misconduct in swap, commodities and energy markets.

Investigation of such failings has increasingly led to consideration of whether similar episodes have occurred globally, including in ASPAC.

These failings have multiple causes, including cultural failings, a push for revenue at the expense of customers and counterparties, ineffective governance and controls, poorly designed processes, inadequate training and an under-investment in enabling technology. There is no single answer to these failings.

These failings have resulted in large costs for many banks, including from fines, the high costs of remediation, the cost of staff, systems and other resources to address the problems, the drain on management time and attention, and reputational damage. Close scrutiny from supervisors and other authorities may lead to the discovery of additional problems, and further costs to some banks.

Indeed, in many respects these failings may prove to be as important to banks and their regulation as the initial financial crisis. They have been a reputational catastrophe for both the banks involved and the wider banking sector.

And these failings have not been confined to Europe and the US. In Singapore, for example, following the MAS' review of the processes relating to banks' benchmark submissions covering the Singapore dollar interest rate benchmarks – the Singapore Interbank Offered Rates (SIBOR) and Swap Offered Rates (SOR) – and the foreign exchange spot benchmarks, twenty banks were found to have deficiencies in the governance and controls for their involvement in benchmark submissions. The banks were required to set aside additional statutory reserves with MAS at zero interest for one year, and were required to conduct independent reviews to ensure the robustness of their remedial measures.

Malaysia is another jurisdiction to have issued new guidelines on (KLIBOR) rate setting.

And there have also been issues in New Zealand. Following an investigation by the New Zealand Commerce Commission into allegations of the mis-selling of interest rate swaps to farmers, a court action is being taken against three of the largest banks in New Zealand in 2014. Also, following litigation launched against banks in Australia, proceedings are being undertaken in New Zealand against five banking institutions for the imposition of unfair penalty fees.

Regulation: the retail conduct agenda

The G20 prioritised consumer protection as one element of its post-crisis regulatory reforms. The Organisation for Economic Co-operation and Development (OECD) developed a set of high level consumer protection principles, which it published in October 2011, and in September 2013 the OECD published a more detailed analysis of the approaches taken by national authorities under three of these principles – disclosure and transparency; responsible business conduct; and complaints handling and redress. This has provided national authorities with a useful check list against which to consider possible gaps in their approaches to consumer protection, and to consider how they might bring their consumer protection framework into line with international good practice.

More generally, there is a growing recognition that transparency and disclosure to retail customers is not sufficient, because retail consumers remain in a weak position in terms of their lack of understanding of many financial products, the imbalance of market power in favour of financial institutions, and the problems caused by various conflicts of interest in retail financial markets.

In previous issues of this publication we have noted that ASPAC regulators have had far less of a focus on conduct issues than their US and European counterparts. However, this is now changing. Singapore, for example, conducted an industry wide review of the financial advisory sector - Financial Advisory Industry Review (FAIR) – with a view towards promoting a culture of fair dealing. The recommendations from the FAIR review included incorporating the assessment of the Board and Senior Management's efforts for delivering fair dealing outcomes to customers into MAS' risk assessments and regulatory reviews, as well as an enhanced complaints handling and resolution framework. The FAIR initiatives will be introduced in stages, with appropriate transition periods, to ensure their smooth implementation by the industry.

On a similar theme, in Hong Kong, the HKMA released a Treat Customers Fairly Charter, aimed primarily at retail consumers, and has also stepped up its efforts in financial consumer education.

In New Zealand, the Financial Markets Conduct Act is a new piece of legislation replacing the current financial markets conduct regulation, focusing on a number of areas including understandable and accurate disclosure and robust governance arrangements for publically available financial products. The Credit Contracts and Consumer Finance Act is also being reviewed with changes being made to strengthen the protection offered to consumers from irresponsible lenders. Supervisory reviews are also being undertaken in respect of compliance with the financial adviser suite of regulations which were implemented in response to the Global Financial Crisis.

In Indonesia, the OJK issued its first regulation regarding customers' protection.

So there are signs that ASPAC supervisors are increasing their focus on this area.

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What are banks doing?

The focus in some countries, including in a number of ASPAC jurisdictions, on the remediation of previous mis-selling and the backward-looking focus of (some) supervision is crowding out more strategic, forward-looking thinking. Some banks view this as a process of working through every past product and service.

Some banks are beginning to take a more strategic and forward-looking approach, as part of a review of 'conduct risk' and/or a shift to a more customer-centric approach. Such banks are focusing on the product life-cycle, including product design and product governance; product complexity and charges; inducements; distribution channels; conflicts of interest; and taking a more outcomes-driven view of customer satisfaction.

This should result in a less product-driven and more customer-centric approach. Laying the foundations of trust will depend on providing more transparency, simplified products and better quality advice, regardless of the sales channel.

Some universal banks are questioning the combination of the provision and the distribution of retail financial products in the same group. For example, some banks have pulled back from offering advice to customers because the regulatory risks are too high to justify the costs of this service, except for high net worth customers. This is also consistent with retail banks shifting to a more automated and less branch-based approach – although automation does not necessarily reduce conduct risk.

In wholesale markets, many banks have already responded to actual and prospective changes to wholesale market structures by re-shaping their wholesale market businesses, and focusing more carefully on which instruments, clients and markets they interact with. They are also looking for ways to industrialise revised operations under these new rules to drive out costs and retain margins.

This is already favouring larger players who have the scale to justify significant investment in technology and process and bear the costs of acting as 'clearing members' – the gatekeepers to central counterparties. Central counterparties themselves are also having to invest heavily, under scrutiny from both these clearing members – who set their own capital at risk through membership – and regulators.

In both retail and wholesale markets banks are ending up with high cost operating models, and large increases in risk and compliance staff, and this is being reflected in the pricing of products and services.

In addition, the regulatory pressures on anti-money laundering, tax and client assets are all pushing up the costs of various forms of client 'on-boarding', the refreshing of client details, and the continuing monitoring of clients and the transactions undertaken with them. Some banks are pulling back from some customers and customer types as a result of the risks and costs involved. This is also making it more difficult for small banks to survive, because some of these costs have a disproportionate impact on smaller banks, which cannot then pass on these additional costs to their customers in a highly competitive market.

Banks are also looking for ways to reduce both costs and conduct risk through the automation of trading and processing. For example, the automation of foreign exchange trading and of the reporting of prices and transactions could reduce conduct risk.

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Calls for culture change are commonplace. Successful implementation is much rarer.

Culture

It is widely argued that fundamental culture change is needed in many banks if the lessons of the crisis are really to be learned and if a more stable, publicly-acceptable banking industry is to emerge. Banks are therefore under considerable pressure to reform their cultures and behaviours, and to regain trust with regulators, customers and the public.

This is driven by a combination of:

- Regulatory and supervisory considerations, reflecting the perceived failings in culture that led (or failed to prevent) some banks to take excessive credit and market risks and to do so on the basis of inadequate capital, funding and liquidity; to mistreat their retail and wholesale customers; to fail to manage conflicts of interest appropriately; and to engage in inappropriate market conduct;
- Shareholders, customers and other market participants, all of whom see negative consequences from investing in, or transacting with, banks with poor standards of culture and behaviour;
- Other influential players such as politicians and the media, for whom banks have made themselves too easy a target; and
- Banks' self-interest in improving their culture and behaviours and learning some of the lessons from the financial crisis – the only way in which banks can roll back the remorseless tide of new regulation is to demonstrate that they have changed sufficiently to make at least some of this regulation unnecessary.

Calls for culture change are commonplace. Successful implementation is much rarer. It is clear that historical practices were wrong, and need to be changed. A fundamental change in culture and behaviour is an essential step on the road to rehabilitation and the creation of a sustainable and safer banking sector for the future. Some banks are beginning to undertake significant reorientation of their business models and their treatment of customers. Hand in hand with cultural change comes the need for banks to understand, monitor and manage talent risk more effectively. For a sector that is so familiar with risk management as a discipline, the extension of the existing risk framework and practices to incorporate people and talent is a powerful way to underpin lasting cultural change.

Banks need to show that the root causes of the behaviour that caused the crisis are being addressed, by demonstrating that they are re-balancing stakeholder interests when making core business decisions. Previously, banks demonstrated a disproportionate focus on profit and employee remuneration at the expense of benefits to the customer or market practice. In future, successful, sustainable business models will be built on the fair balance of stakeholder interests.

Many global banks have started top to bottom cultural change programs. This approach often includes:

- A new 'tone from the top' – clear and public commitments from the chairman and CEO that the old ways of working are not acceptable, and that the journey towards a 'new bank' will include major culture change;
- New, high profile value statements and codes of conduct usually including a principle of ethical, responsible banking and the importance of fair and high quality service for customers;
- A redefinition of the skills and behaviour needed to deliver the business strategy, in an environment focused on risk management, transparency and ethical behaviour;
- Reformed mechanisms (including reward structures) to stop unwanted behaviour being reinforced through misaligned reward and promotion processes; and
- Changes to risk culture, through a strengthening of the role of the Chief Risk Officer and of the risk management and compliance functions.

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However, this may not be sufficient to drive fundamental change in culture and behaviour throughout banking organisations. This will require, at least:

- A true commitment from senior executives to transformational change, including a review of the core beliefs and routines that exist within the bank. To be effective it is vital to have visible and authentic role-modelling of values, with leadership demonstrating decisive action to prevent the re-emergence of unacceptable behaviour;
- Some high impact, symbolic actions that demonstrate that the bank is taking culture change seriously, and that there is no going back. These actions could include pulling out of certain business activities, and stopping the sale of, or redesigning, products that are perceived to be contentious or unfair;
- A radical overhaul of traditional norms and routines. This should include variable remuneration incentives – removing them in some cases, and at least adopting a meaningful balanced scorecard approach, with a genuine input from the risk and compliance functions;
- A structured approach to managing people risk, and the incorporation of talent risk into wider risk management governance and reporting; and
- The articulation of clear measures and performance indicators for judging success in changing culture and behaviours, and the communication of these measures and indicators both internally and externally.

Hand in hand with cultural change comes the need for banks to understand, monitor and manage talent risk more effectively.

Impact on customers

Customers should benefit from banks becoming more customer-centric, improving their customer treatment, and enhancing their culture and behaviours. Some customers may also welcome a shift to simpler products sold through more transparent and fairer distribution channels.

However, these improvements also involve costs. In part these arise from higher compliance costs and the frictions added by regulatory requirements to operating models and business models. This will lead to higher prices, fewer providers and distributors, and in some areas to a reduced range of products and to simpler products. Banks are refusing to deal with some customers because the economic costs and regulatory risks of doing so are too high.

In the retail market this raises the possibility of a different 'tipping point', in which regulation has an adverse impact on the amounts of saving, investment and protection that consumers undertake. One particular problem here is that many of these products have to be sold to consumers rather than being willingly bought – so one impact of tougher regulation is simply to reduce the extent to which banks actively sell these products, resulting in what has been described as the 'stability of the graveyard'.

In both retail and wholesale markets, the squaring of the circle on costs, regulation and revenues will inevitably mean that most customers will end up paying more for banking products and services; and some customers will find their choices constrained as banks pull back from markets, geographies and even the types of customer they are prepared to deal with. ■

In both retail and wholesale markets, the squaring of the circle on costs, regulation and revenues will inevitably mean that most customers will end up paying more for banking products and services; and some customers will find their choices constrained as banks pull back from markets, geographies and even the types of customer they are prepared to deal with.

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'The price of light is less than the cost of darkness.'
Arthur C Nielsen

04 Data and Reporting

Banks face three major challenges around data management: to hold and use the right data to serve their customers; to meet the wide-ranging and exponential increases in demands from regulators and others for reporting and disclosures; and to respond to supervisory concerns that banks do not have the right data, systems and IT architecture to enable them to manage their risks effectively.

Banks face three main pressures for change in their data and reporting:

- The significant increase in external reporting requirements;
- Regulatory pressure to improve their internal aggregation and reporting of risk data; and
- Business pressures to make better use of their data and to improve the efficiency of their data handling.

This is creating substantial costs for banks, and tough decisions over the prioritisation of competing IT projects. Some banks run the risk of building a castle on the sand here, given the absence of existing robust systems.

Meanwhile, banks also need to address the new and unforeseeable risks in data privacy and cybercrime, conflicting national laws and the impact of retrospective investigations, in an environment where vast amounts of data are indefinitely available.

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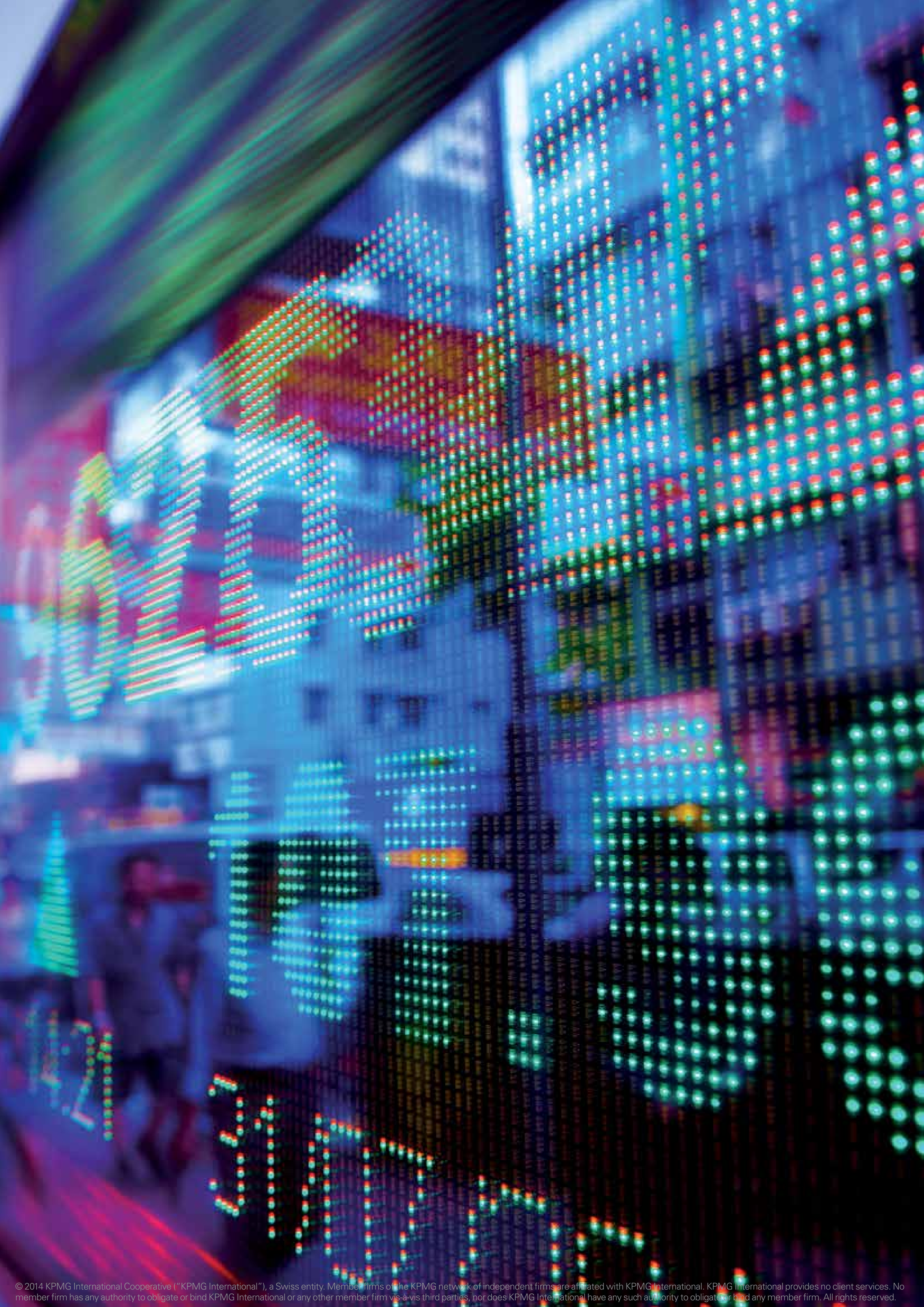

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Regulation and supervision

One clear consequence of the financial crisis has been a significant increase in the amount and granularity of data that banks are being required to report to their regulators (see box) and/or to disclose directly to investors and other market participants. Every new regulation brings with it additional reporting requirements, as does the increase in supervisory intensity and coverage, and the growing emphasis on stress and scenario testing. This places considerable costs on banks in terms of the people, systems and quality assurance processes necessary to support this reporting.

This myriad reporting and disclosure requirements also has an immediate impact on banks' procedures for data capture, data reconciliation (across systems, and between regulatory reporting and financial statements), control processes, and review and governance procedures.

This is being reinforced by the growing emphasis of supervisors on the quality and accuracy of reported data and other information, which in turn has led to an increased focus on individual responsibility for reported data, on banks' internal assurance processes (including the role of internal audit), and on governance (how a bank's non-executive directors gain assurance about the quality of reported data).

The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly, accurately, and across all risk types, activities and geographies.

INCREASE IN REGULATORY REPORTING REQUIREMENTS

Banks face an exponential increase in regulatory reporting requirements.

INCREASE IN REGULATORY REPORTING REQUIREMENTS

RECOVERY AND RESOLUTION PLANNING

Banks are having to provide very detailed information on recovery plans, and to assist resolution planning by the authorities.

MARKET DISCLOSURES

Enhanced 'Pillar 3' disclosures by banks, including standard templates and greater transparency on internal model-based approaches.

SINGLE CUSTOMER VIEW

Banks are expected to be able to report to regulators their aggregate exposure position to single customers at short notice consistent with deposit insurance arrangements.

ANTI-MONEY LAUNDERING AND TAX

Although the details differ, there are growing data and reporting demands on customer due diligence, customer classification, and the reporting of specific information to various authorities.

MACRO-PRUDENTIAL OVERSIGHT

National, regional and international macro-prudential authorities are increasing rapidly their collection of system-wide data, including on inter-connectedness within the banking system, and the role of banks in securities financing transactions and in funding the shadow banking sector.

STRESS TESTING

Regular reporting is increasingly being supplemented by one-off requests to banks to supply data for stress-testing and other purposes.

INDIVIDUAL NATIONAL SUPERVISORS

Multiplicity of detailed national reporting requirements introduced since the financial crisis.

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There are also wider issues for banks here, relating not just to data capture but also to how the full range of reporting requirements are identified, and to how data are used to 'police the boundaries' in terms of meeting regulatory requirements, including how activities and transactions are categorised in order to ensure that they are undertaken in the appropriate legal entities.

Banks will need extensible and scalable data to meet all these requirements, perhaps ultimately in the form of a single 'data tape' that can be captured and interrogated by supervisors and other authorities.

Supervisors have also become increasingly frustrated by the inability of major banks to aggregate their risk exposures quickly and accurately at group level, both for internal reporting purposes and for meeting information requests from supervisors. These supervisory concerns are not limited to the state of banks' IT architecture and data gathering – they also extend more generally to the internal reporting of risk data and the use of these reports as an input to properly-informed risk and business decisions.

The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly, accurately, and across all risk types, activities and geographies; and to the ability of banks to produce and use high quality management information both routinely and in response to emerging risks as an input to high quality decision making.

The Basel Committee issued a set of Principles on risk data aggregation and reporting in January 2013, and challenged G-SIBs to self-assess themselves against these principles during 2013 (see box). G-SIBs are expected to meet these Principles by 2016, while D-SIBs should do so within three years of being designated as a D-SIB (it is left to national supervisors to undertake this designation). Supervisors may apply the Principles to other banks (and to non-banks) on a proportionate basis.

RISK DATA AGGREGATION AND REPORTING

In January 2013 the Basel Committee published 14 Principles on the aggregation and reporting of risk data.

The Principles cover:

- The importance of Boards and senior management exercising strong governance over a bank's risk data aggregation capabilities, risk reporting practices and IT capabilities. This includes
  - the documentation, validation and robustness of these capabilities and processes;
  - the design, build and maintenance of data architecture and IT infrastructure to support risk data aggregation capabilities and risk reporting practices both in normal times and during periods of stress.
- The accuracy, integrity, completeness, timeliness and adaptability of aggregated risk data. This includes
  - the adequacy of the systems and controls that generate risk data and its aggregation; and
  - the capability to adapt rapidly to changes in key risks and regulatory requirements.
- The accuracy, comprehensiveness, clarity, usefulness, frequency and distribution of risk management reports, including to the Board and senior management. This includes
  - procedures for monitoring the accuracy of data and model reliability;
  - making good use of forward-looking assessments of risk; and
  - reviewing the usefulness of risk management reports to senior management and the board.
- The need for supervisors to review and evaluate a bank's compliance with these principles, to take remedial action as necessary, and to cooperate across home and host supervisors.

Banks' self-assessment against the principles

The Basel Committee published in December 2013 a self-assessment by 30 G-SIBs of their progress in meeting the risk data aggregation and risk reporting principles.

The results show that the three principles with the lowest reported compliance related to data aggregation: data architecture and IT infrastructure, the accuracy and integrity of data, and adaptability. Nearly half of the banks reported material non-compliance on these principles, and many reported that they are facing difficulties in establishing strong data aggregation processes, and are therefore having to resort to extensive manual workarounds.

Banks self-assessed the highest compliance on the principles relating to the reporting of risk data: report distribution, and the comprehensiveness, clarity and usefulness of reports.

However, the Basel Committee found it odd that risk data reporting scored better than governance, since the governance principles should be preconditions to ensure compliance with the other principles; and that some banks rated themselves fully compliant on comprehensiveness but materially non-compliant on one or more data aggregation principles. This raises a question as to how reliable and useful risk reports can be when the data within these reports and the processes to produce them have significant shortcomings.

The Basel Committee concluded that banks need in particular to:

- Upgrade significantly their risk IT systems and governance arrangements, with an emphasis on formal and documented risk data aggregation frameworks, comprehensive data dictionaries that are used consistently by all group entities, comprehensive policy governing data quality controls, and controls at each stage of the life cycle of data;
- Improve the accuracy, completeness, timeliness and adaptability of their risk data, with less reliance on manual processes, and quality checks on risk data that are as robust as those supporting accounting data; and
- Generate relevant data on a timely basis to meet evolving internal and external risk reporting requirements.

These self-assessment findings are reinforced by the conclusions of the Senior Supervisors Group, published in January 2014, which examined the quality of banks' large exposures data. The Group found that banks' progress towards the consistent, timely and accurate reporting of large exposures failed to meet both supervisory expectations and industry best practice.

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What are banks doing?

Risk data

Many banks are struggling to meet all these Principles, although the extent of the gap will depend on how stringently the Principles are interpreted by national supervisors.

Banks should be reviewing:

- The quality and harmonisation of the risk data they collect;
- Their ability to aggregate risk data effectively, including across legal entities and geographies within a banking group;
- The use of IT to streamline data management and to make it more efficient;
- The ability to bring together risk and finance data;
- The internal reporting of aggregated risk data, including to senior management and the Board, and the use of this information for decision-making; and
- Governance (at Board and senior management level) procedures for risk data aggregation and reporting, including the bank's IT capabilities in these areas.

Many large banks are currently at the gap analysis stage of self-assessment, identifying areas where they need to make improvements. The design and implementation of the necessary improvements will follow, much of which will require large-scale and expensive projects to introduce a new IT infrastructure. These projects will need to be integrated with related initiatives in areas such as corporate governance and risk governance, stress and scenario testing, management information, IT enhancements and external reporting (both to regulators and to other stakeholders). These enhancements will then need to be supplemented by the provision of assurance through external reviews of data management, data aggregation and data reporting.

RISK DATA AGGREGATION AND REPORTING: FROM PRINCIPLES TO ACTIONS

The principles translate into four key areas of impact

1. Governance
2. Data architecture and IT infrastructure
3. Accuracy and Integrity
4. Completeness
5. Timeliness
6. Adaptability
7. Accuracy
8. Comprehensiveness
9. Clarity and usefulness
10. Frequency
11. Distribution
12. Supervisory review
13. Remedial actions and supervisory measures
14. Home/host cooperation

IT ARCHITECTURE

- Risk data models unified or automatically reconcilable across banking group with unified naming conventions
- Unified level of detail of data across the group to enable fully flexible reporting
- Risk and accounting data to be reconciled
- High degree of automation for risk data aggregation
- Strive for single source of risk data for each risk type

DATA QUALITY FRAMEWORK

- Effective data quality management including automated measurement methods and escalation procedures
- Comprehensive data governance for risk data including data owners from business and IT
- Documentation of reporting and reconciliation processes
- Automatic and manual quality checks in the reporting process

RISK REPORTING

- Adaptable and ad hoc reporting capability with drill-down into various risk dimensions, stress testing
- Comprehensive, timely, dependable and adaptable risk reporting capability across all units and all material risks
- Ability to do trend analysis

ORGANISATIONAL AND IT MANAGEMENT

- Risk reporting and aggregation to be mapped into IT strategy/ implementation roadmap
- Independent validation of standard compliance
- Full business continuity capability for risk reporting

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Many banks will struggle to deliver the required improvements within the deadlines set by the Basel Committee, given the need to redesign systems. This may crowd out other systems and IT improvements for banks' strategic and commercial purposes.

Exploiting data

Banks hold vast amounts of data, but these data are usually held in multiple forms and places that do not communicate effectively with each other or with central data processing centres. As a result, banks find it difficult to gather and exploit data on their customers. This in turn makes it difficult for banks to connect effectively with their customers; to identify profitable areas of business (by products, customers, business lines and geographies); and to drive simplification.

Banks need to exploit better the technological advances that are enabling more effective customer profiling in both the retail and wholesale sectors.

Indeed, the disconnect between banks and their customers may be widening, not least relative to rising customer expectations based on their experiences with firms in other industries who have performed better than the banking industry in using technological advances to understand their customers better and to communicate more effectively with them.

Banks therefore need to extract more value from their data, not only to deliver against their aspirations to become more customer-centric and less product-driven, but also to remain competitive both with other banks and with potential new entrants to banking markets.

The real competitive advantage here will come from the successful integration and analysis of all sources of customer and market data to develop a better understanding of customer needs and thereby to enable banks to serve these customers more effectively, efficiently and profitability.

But even if banks begin to place more value on data and invest more in data analytics, they will remain constrained by their IT infrastructures. These infrastructures are typically characterised by multiple disparate, aging and increasingly unreliable systems that have been stitched together during a period of mergers and acquisitions, entry into new areas of business, and a poorly managed series of IT enhancements in different areas of a bank's business.

The IT infrastructure of many banks requires immediate and expensive attention from a group-wide perspective before it becomes wholly unsustainable – as is demonstrated by the increasing frequency of system outages and data loss incidents.

The pressure is growing on banks to break out of this unfortunate state of affairs, not least because banking is increasingly a technology business, and many of the potential competitors of banks may come from firms who are much more adept at technology, at the exploitation of customer data, and at providing high levels of customer service.

Harnessing technological advances would enable banks to:

- Streamline their operations and reduce operating costs;
- Connect better with existing and new customers across a multitude of existing and emerging communication channels, thereby enhancing customer satisfaction and loyalty;
- Build better defences against the rising threat of cyber crime (be it internal or external attempts to siphon funds from the bank or 'denial of service' attacks from various potential sources);
- Introduce greater industrialisation of processes in order to simplify, standardise and consolidate operations and thereby to reduce complexity, reduce costs and enhance customer service;
- Introduce automated smart systems which may provide at least part of the solution to a number of AML, tax and trading concerns, and may provide scope to transform compliance and internal audit;
- Reduce the costs – be they financial, regulatory or reputational – that emerge eventually from poor data and IT systems, not least because these poor data and IT systems facilitate bad decision-making and inappropriate behaviours; and
- Contribute effectively to the moves in some countries towards a new core banking system.

Equally, however, the familiar concerns remain. The up-front costs of IT and data projects arise at a time when banks' profitability is weak and pressures for cost reduction are strong. Banks need to decide how much change to introduce – shortcomings need to addressed, but the search for perfection raises the spectre of costs exceeding benefits. And regulatory reporting requirements are already crowding out other IT and data projects.

Impact on customers

If banks are successful in making better use of customer data there should be benefits for customers from banks designing, marketing and distributing products and services in ways that better meet customer needs; improvements in the ease of interaction with banks; and faster and more accurate levels of service.

Meanwhile, investors should benefit from bank disclosures that make it easier to understand the risks that banks are taking, how they measure and manage these risks, and how much capital they hold against these risks.

But there is also a cost point here – banks need to spend substantially on systems over next three to five years. There may be a payback eventually, but the up-front costs will be borne by customers and shareholders. ■

Banks need to exploit better the technological advances that are enabling more effective customer profiling in both the retail and wholesale sectors.

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'Risk comes from not knowing what you are doing.'
Warren Buffett

05 Risk Governance

A key lesson of the financial crisis was that the governance of many banks was ineffective, resulting in poor quality decision-making and poor quality oversight of risk by bank Boards.

Fundamental change is required across all aspects of risk governance. Standard setters have begun to define what good risk governance looks like, while banks have begun to move towards higher governance standards.

But in many banks this remains unfinished business.

Banks need to do more in the area of risk and governance. New risk management and risk reporting procedures are being introduced, but roles and responsibilities have not always been fully determined, leading to both underlap and overlap. Many banks need quite different management information which only significant investments in core and critical systems will provide. And most banks have not yet reached a stage where their risk management function is genuinely strategic and forward-looking.

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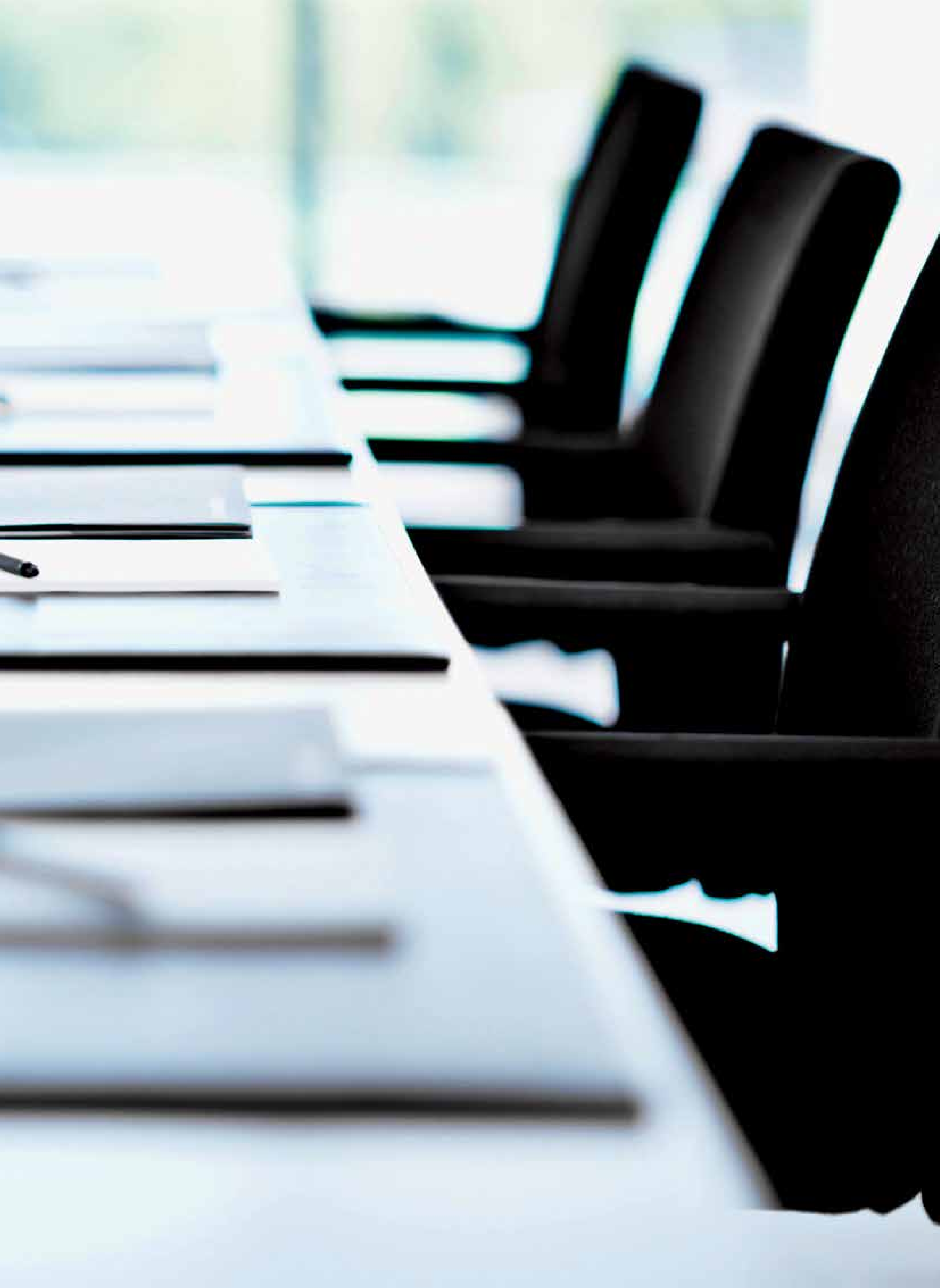

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SOUND RISK GOVERNANCE PRACTICES

A thematic review undertaken by the FSB of 36 banking groups across the G20 area showed that these firms had made improvements since the financial crisis in risk governance, not least in:
- Assessing the collective skills and experience of the Board;
- Undertaking more frequent and more demanding Board effectiveness reviews;
- Instituting a stand-alone risk committee; and
- Establishing a group-wide CRO.

However, these groups had made less progress in:
- Establishing and implementing a clear risk appetite statement;
- Defining the responsibilities of the risk committee and its interactions with the audit committee; and
- Strengthening risk management functions, in particular IT infrastructure and the ability to aggregate risk data efficiently and effectively. The review drew a clear link here to the Basel Committee principles on risk data aggregation and reporting.

The FSB used examples of good practice to develop a set of sound risk governance practices for banks to aspire to, and for national authorities to use as a basis for assessing risk governance in major financial institutions. The FSB also recommended that international standard setters and national authorities should adopt more consistent approaches and should toughen their standards to reflect these sound risk governance practices.

The sound risk governance practices identified by the FSB include:
- The independence and expertise of the Board;
- The role of the Board in establishing and embedding an appropriate risk culture throughout the firm on a business line basis, a legal entity basis, and a group basis;
- The membership and terms of reference of the risk and audit committees;
- The reporting lines of the CRO (direct to the CEO, not through the CFO) and a distinct role from other executive functions and business line responsibilities;
- The importance of CRO involvement in all significant group-wide risks (including treasury and funding) and in key decision-making processes from a risk perspective (including strategic planning, acquisitions and mergers);
- The independence, authority and scope of the risk management function; and
- The independent assessment of the risk governance framework, including both an enhanced role for internal audit and the use of external third parties.

The review found significant gaps in all the banking groups in its sample, so banks should not assume that they are performing well against these criteria.

Regulation and supervision

Since the financial crisis, many national authorities have strengthened their rules and guidance on corporate governance and risk governance, reflecting both local initiatives and new international standards from the FSB, the Basel Committee and the OECD.

New rules and guidance have typically included requirements on banks to:
- Undertake more detailed Board oversight of risk and risk management;
- Strengthen the composition of the Board and its sub-committees, including the independence, expertise, time commitment and diversity of non-executive directors;
- Clarify individual responsibilities and accountability;
- Establish a risk committee of the Board;
- Enhance the risk management function and the role of the Chief Risk Officer (CRO), in terms of independence, expertise, stature, authority and scope; and
- Undertake independent assessments of the bank's risk governance framework, through Board effectiveness reviews, internal audit assurance reviews and third party assessments.

Meanwhile, supervisors have increased their supervisory efforts by engaging more frequently and intensively with the Boards and senior management of banks. This has included more frequent and intensive on-site reviews of risk governance, including meetings with non-executive directors. They are also requesting enhanced reporting on banks' risk management practices, including information on exposure limits, stress testing, Board and sub-committee minutes, and reports on risk governance from external auditors and other third parties.

However, the implementation of these initiatives has been uneven, both across national supervisors and across banks.

Based on these regulatory and supervisory developments, and on a review of risk governance practices in major banking groups, the FSB published in February 2013 a set of sound risk governance practices (see box above), focusing in particular on the role of the Board and the role of non-executive directors; the group-wide risk management function and the role of the CRO; and the independent assessment of risk governance.

In Australia, APRA's Risk Management prudential standard requires the establishment of a three lines of defence risk management and assurance structure. It also specifies, consistent with the FSB Principles: the required minimum components for an acceptable risk management framework; establishing a Board Risk Committee and CRO; requirements for the formal review of the implementation and effectiveness of the framework; and the coverage of issues to be addressed in a risk management declaration from the Board.

In November 2013 the FSB extended its guidelines on risk governance with two further papers: a set of Principles for an effective risk appetite framework (see box on page 39), and a consultative document on Guidance to supervisors on assessing the risk culture of financial institutions (see box on page 40).

Many banks will struggle to meet these Principles for an effective risk appetite framework. Banks are already grappling with the challenges of:
- robustly defining a risk appetite for non-financial risks;
- setting risk limits across business units and entities;
- embedding risk appetite within a wider risk culture;
- defining in a meaningful way risk culture at bank and group level, and in applying it effectively across the group, as well as integrating it into KPIs, staff performance assessments, and remuneration incentive structures;
- developing risk appetite statements at group level, as well as for individual entities within the group, and doing that cross-border;
- integrating stress testing analysis into risk appetite and risk management frameworks.

Meanwhile, for many banks the implementation by supervisors of the Guidance on assessing risk culture will represent a significant increase in supervisory intensity, and a shift in the direction of supervision into areas that some supervisors may not have focused on in the past. This will be even more pronounced if this approach to supervision extends down into D-SIBs and beyond. For

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Many banks will struggle to meet these Principles for an effective risk appetite framework.

example, the Bank of Italy issued in July 2013 a substantial update of the rules for the banking sector, including a requirement on banks to define and implement a risk appetite framework.

We have also seen a number of regulators in the region enhancing the use of stress testing. For example, the RBNZ introduced a new stress testing exercise for all New Zealand banking institutions – to obtain an overall view of and enhance the capability and performance of these tests within the banks.

This increased supervisory interest in risk culture will require banks to demonstrate that they have:

- **Embedded a clear set of values and culture at all levels of the organisation;**
- **Learnt from risk culture failings;**
- **Clearly allocated risk ownership;**
- **Encouraged internal challenge to perceived poor behaviours; and**
- **Implemented a remuneration framework that genuinely reflects performance against compliance and risk management.**

As with corporate governance more generally, progress on developing global standards for risk governance may not result in consistent calibration and implementation across jurisdictions. It is not clear to what extent monitoring through country and peer reviews by the FSB and the Basel Committee will deliver greater consistency, given the complexity and diversity of large banks and different national supervisory approaches.

RISK APPETITE FRAMEWORK

The FSB's Principles for an effective risk appetite framework recognise that the concept of risk appetite was not always well understood, quantified or embedded in business management. The Principles state that the framework should:

- Be driven by both Board leadership and the involvement of management at all levels;
- Be communicated, embedded and understood across the bank, including being embedded into the bank's risk culture;
- Act as a brake against excessive risk-taking;
- Allow for the risk appetite statement to be used as a tool to promote robust discussions of risk and as a basis upon which the Board, risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;
- Cover subsidiaries and third party outsourcing suppliers that may be outside the direct control of the bank; and
- Be adaptable to changing business and market conditions.

The FSB then define the three key elements of an effective risk appetite framework as:

→ A risk appetite statement that:

- Is linked to the bank's short- and long-term strategic, capital and financial plans;
- Establishes the amount of risk the bank is prepared to accept in pursuit of its strategic objectives and business plan, taking into account the interests of its depositors and shareholders as well as capital and other regulatory requirements;
- Determines for each material risk the maximum level of risk that the bank is willing to operate within, based on its risk appetite, risk capacity, and risk profile;
- Includes quantitative measures that can be translated into risk limits applicable to business lines, legal entities and groups;
- Includes qualitative statements for risks that are not easy to measure, including reputational and financial consequences of poor management of conduct risks across retail and wholesale markets;
- Ensures that the strategy and risk limits of each business line and legal entity align with the bank-wide risk appetite statement; and
- Is forward looking and subject to scenario and stress testing to ensure that the bank understands what events might push the bank outside its risk appetite and/or risk capacity.

→ Risk limits that interact with the risk appetite because they:

- Constrain risk-taking within risk appetite;
- Are established for business lines and legal entities, and include material risk concentrations at the firm-wide, business line and legal entity levels (e.g. counterparty, industry, country/region, collateral type, product);
- Do not default to regulatory limits, and are not overly complicated, ambiguous, or subjective; and
- Are monitored regularly.

→ A set of supporting roles and responsibilities – the Principles include detailed job descriptions that outline the roles and responsibilities of the Board and senior management with respect to the risk appetite framework.

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ASSESSING RISK CULTURE

The FSB's proposed Guidelines are intended to support supervisors in taking a judgemental, outcomes-focused and forward looking approach. Supervisors should understand an institution's risk culture, in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework. To achieve this, supervisory interaction with Boards should be stepped up, based on high-level sceptical conversations with the Board and senior management on the bank's risk appetite framework, and on whether the bank's risk culture supports adherence to the agreed risk appetite.

Supervisors will be expected to focus on four key 'risk culture indicators', looking in particular for behaviours or attitudes that are not supportive of sound risk management, and intervening early to address these culture observations and thereby the potential build-up of excessive risk.

The four indicators are:

→ **Tone from the top** – how the bank's leadership ensures that its core values are communicated, understood, embraced and monitored throughout the organisation. This includes leading by example, assessing the impact of the high level values on behaviour throughout the organisation, ensuring common understandings of risk, and learning from risk culture failures;

→ **Accountability** – a clear allocation of risk ownership, escalation processes, and internal enforcement procedures;

→ **Effective challenge** – encouraging challenge and dissent, and organising the risk functions to provide access of risk and compliance to senior management and the Board; and

→ **Incentives** – basing remuneration on adherence to risk appetite and to desired cultures and behaviours, and appropriate talent development and succession planning.

In many major banking groups there has been a significant shift in the relative importance of the business units and risk management.

What are banks doing, and what more do they need to do?

Banks have made progress in improving governance and risk governance, but most banks need to make further progress in these areas.

Focus on risk

At Board level, more attention is now being focused on understanding risk, on setting risk appetite, and on controlling, measuring, monitoring and reporting risk. This includes a reinforcement of the Board with non-executive directors who bring a deeper experience and expertise of banking and risk management; a more active role for the Board risk committee; a closer consideration of risk maps and risk related management information; and a more active role for the CRO in discussing risk with the Board risk committee and/or the Board itself.

However, at many banks the shift from the pre-crisis problem of inadequate and fragmented oversight – with information not being properly reported upwards from overly-independent business divisions – to much improved group-wide risk data being reported to the Board on a timely basis, remains incomplete. This relates closely to the problems in risk data aggregation and reporting discussed in Chapter 4.

As the volume and nature of internal and regulatory risk reporting grows many banks will need to invest further in risk data, systems, and architecture.

Meanwhile, the localisation agenda and the need to place additional emphasis on specific risks such as liquidity, conduct and reputational risk will make it even more challenging for a CRO, senior management and the Board to form a group-wide view of the risk profile and to manage the global business across regional, national, product and legal entity lines. As the cost of capital and funding increases there will also be an increasing need to consider the risk adjusted return on particular products and services.

Banks also need to consider how risk governance adds value within the organisation and to define clearly the role and mandate of functions and individuals with regard to risk management responsibilities.

Given all these responses to regulatory and other pressures, many Boards have asked whether they have sufficient time to consider strategic and commercial decisions.

Oversight and accountability

Banks are beginning to respond to pressures from their supervisors to provide real clarity of accountability across core business activities and processes. This requires end-to-end oversight and ownership of these activities and processes. However, senior management in many banks have struggled to agree such accountability.

Banks need to develop and implement the necessary ownership of, and accountability for, their core business activities and processes. And they need to reach a position where they can attest with confidence to the clarity and effectiveness of these roles and responsibilities.

Role of the CRO

Many banks have reviewed and revised the role, responsibilities and reporting lines of the CRO, and in doing so have generally enhanced the CRO function. In line with the FSB guidelines, CROs increasingly report directly to the CEO rather than through the Chief Financial Officer (CFO), and have much greater access to the Board and the Board risk committee.

However, in some banks this remains work in progress, with issues still to be resolved around:

- **How a CRO can establish a genuinely group-wide view of risk, in particular with respect to (i) the capital, funding and liquidity issues that have traditionally been the responsibility of the CFO; and (ii) the operations of a bank – be they specific business activities or geographies – that have traditionally been managed independently;**
- **How banks can establish an enhanced group-wide view of risk alongside the local view of risk that continues to be required by many national regulators; and how banks can meet the strategic challenge of having to balance centralised group risk management, decision making and control with the need to demonstrate that the local Board of each regulated entity remains accountable for the viability, sustainability and resolvability of that entity.**
- **The bifurcation of reporting (and the consequent need for some form of matrix management) between business lines and risk management, at all levels of a bank, including reporting to the Board; and**
- **The capacity and ability of CROs – and the risk management function more generally – to take a forward-looking and strategic view of risk. There needs be a strong proactive view of risk, not just a reactive and backward-looking monitoring of limits and procedures.**

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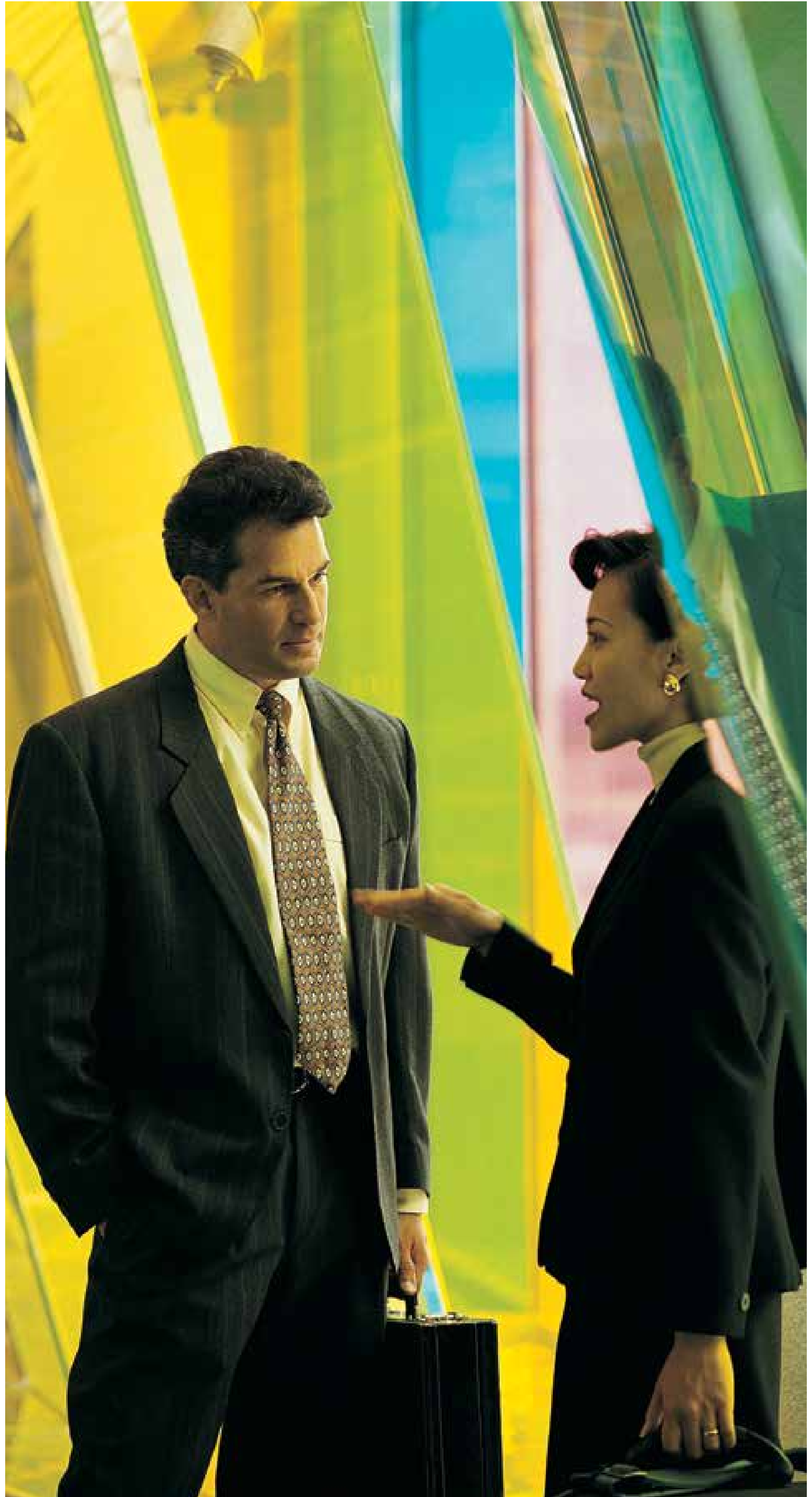
Risk management

In many major banking groups there has been a significant shift in the relative importance of the business units and risk management. More risk management is now embedded in the 'first line of defence' (the business units), which has shifted from being almost entirely revenue-driven to being more risk constrained and obligation-driven. Some banks have also restructured the second and third lines of defence, with the second line (including risk management) becoming more dominant, more powerful, and more centralised; and with an enhanced third line (including internal audit) to provide more robust assurance that systems and controls are operating effectively.

However, risk management remains under-resourced in some banks, and in some cases the shifts in the first and second lines of defence are far from smoothly embedded.

A renewed focus on an effective three lines of defence approach to risk management may call for further investment and up-skilling within the first line, while an independent second line refocuses its priorities around advice, framework design, effective challenge and risk aggregation to identify concentrations and correlations across the bank. Regulatory reforms designed to improve the independent assessment of the effectiveness of risk governance may also call for significant investment and up-skilling in the third line, to provide positive assurance on the effectiveness of risk policies, processes and controls. ■

At many banks the shift from the pre-crisis problem of inadequate and fragmented oversight – with information not being properly reported upwards from overly-independent business divisions – to much improved group-wide risk data being reported to the Board on a timely basis, remains incomplete.



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06 OTC Derivative Reforms

The ongoing OTC derivative reforms are having a significant impact on banks in the region. So far, the most challenging aspect of the OTC derivative reforms for many banks has been responding to the extra-territorial aspects of the US Dodd-Frank and European EMIR regulations. Major jurisdictions in the region have made significant progress in implementing their OTC derivative reforms and we expect to see more requirements come into force in the next year. A number of uncertainties remain and the end-state for OTC derivative markets in ASPAC has yet to be reached.

Unique challenge in the ASPAC region

OTC derivative reform has presented a particular challenge to banks operating in ASPAC due to the combined impact of a patchwork of local regulations being implemented in many of the key markets in the region and regulations introduced outside the region which have extra-territorial implications. Global banks which operate in the region have found that they need to supplement their global Dodd-Frank and European Market Infrastructure Regulation (EMIR) compliance programs with more localised ASPAC projects that address the specific requirements of local regulations. Banks in the region which deal with US persons, or which are headquartered in the European Union (EU) have needed to study carefully the impact of Dodd-Frank and EMIR on their business model. All banks in the region, including local banks which are not directly in scope for either the US or EU requirements have been indirectly impacted to a greater or lesser extent by the changes in the OTC derivative markets which have resulted from these reforms.

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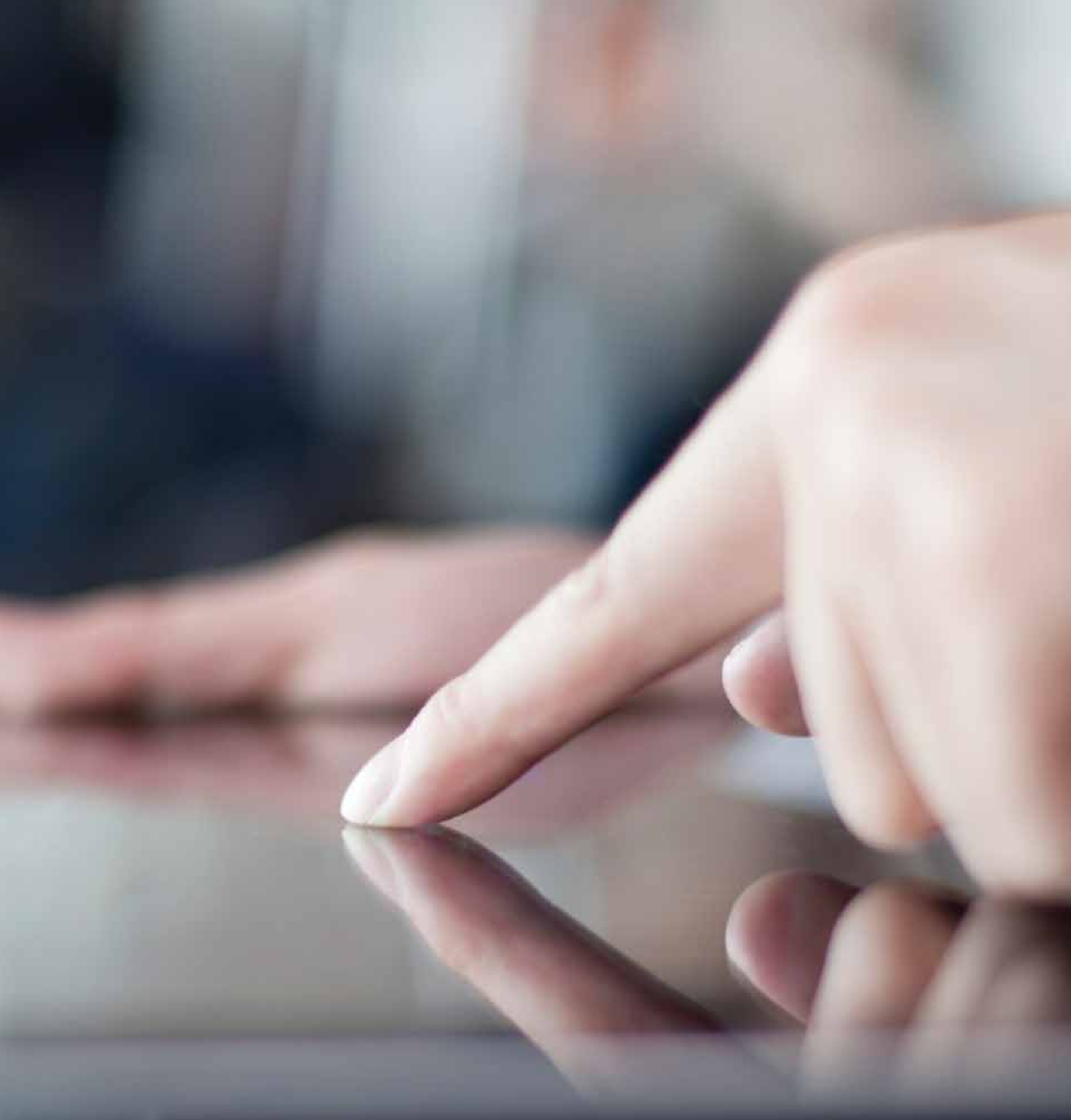

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Progress made in implementing the G20 commitments

Significant progress has been made by individual jurisdictions in implementing the G-20 commitments in respect of mandatory reporting and mandatory clearing of OTC derivative transactions.

Mandatory reporting

Where mandatory trade reporting requirements are already in place, these differ from country to country both in terms of the types of instrument in scope for reporting, the size of reporting thresholds as well as the extent to which different types of regulated and non-regulated entity are captured by the requirements. Some jurisdictions, including Hong Kong and Singapore, have indicated that they intend to impose reporting requirements under certain circumstances where instruments have been executed in their market but booked elsewhere. Whilst some jurisdictions already allow the use of a global trade repository to meet local reporting requirements, others have not yet put in place the necessary registrations and regulations that would permit this.

Mandatory clearing

Again, the scope of mandatory clearing obligations differs from jurisdiction to jurisdiction in terms of instruments and entities in scope and the size of clearing thresholds. A number of jurisdictions, including Australia, Hong Kong, Korea and Singapore are in the process of finalising necessary legislation and/or regulations with the mandatory clearing obligation expected to be introduced in 2014 in some cases. The region now has a number of Central Counterparties (CCPs), each with their own collateral, margin and default fund requirements. Not all CCPs yet permit client clearing and whilst most jurisdictions allow clearing obligations to be satisfied through use of a recognised overseas CCP, there are a few jurisdictions where the domestic CCP must be used.

Mandatory trading on electronic platforms

Overall, regulators in the region have seen less immediate need to introduce the obligation for participants in their markets to trade OTC derivatives on electronic platforms. In a number of cases, regulators have said they will study data on their market collected through trade repositories before reaching a conclusion on whether or not such an obligation is required. So far, only Japan has set a firm date for introduction of such a requirement and requirements around use of electronic trading platforms remain an area of uncertainty for the region as a whole.

	Mandatory Reporting	Mandatory Clearing	Mandatory Trading on Electronic Platforms
Australia	The first phase of the reporting obligation commenced in October 2013.	Legislation was passed in December 2012 but detailed regulations are still being drafted.	Obligation could be introduced without further legislation but no indication yet if/when such obligation will be introduced.
China	Some reporting requirements already in place although changes are expected.	No details have yet been announced for mandatory clearing obligation, but it is expected to be introduced sometime in 2014.	No announcement yet made on any mandatory obligation.
Hong Kong	Legislation going through legislative process, detailed regulations not yet published.	Legislation going through legislative process, detailed regulations not yet published.	Legislation will give regulators power to introduce the obligation but no indication yet if/when such obligation will be introduced.
India	Regulatory guidelines already issued by RBI.	Implementation postponed indefinitely.	Possible implementation from the end of 2014.
Japan	In place since November 2012	In place since November 2012.	2012 legislation indicated that obligation will be introduced by September 2015
Korea	Some reporting requirements already in place although changes are expected.	Commencement date for mandatory clearing date has been postponed to 30 Jun 2014.	Review of policy options for mandatory trading of OTC derivatives on electronic platform or exchanges is underway.
Singapore	Reporting commencement date for interest rate and credit derivatives is 1 April 2014, other derivative classes from October 2014.	Legislation passed in 2012. Detailed regulations not yet released; mandatory obligation could be introduced in 2014.	Introduction of mandatory obligation to be deferred pending further industry consultation.

Key

- Proposal not yet published
- Consultation published
- Legislative process underway
- Legislative process complete, pending introduction of regulations to impose mandatory obligation
- Mandatory obligation in place

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Capital and margin requirements

Jurisdictions which are implementing Basel 3 have mostly confirmed that they will be following the Basel approach for the treatment of exposures to CCPs, although as mentioned in chapter 1 of this report there are some remaining uncertainties over exactly what the final Basel 3 approach to OTC derivative exposures will be.

The Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO) released their final framework for margin requirements for non-centrally cleared derivatives in September 2013. A number of regulators from the ASPAC region participated in the working group which drew up these requirements. It is not yet clear, however, how these will be implemented in individual jurisdictions in the region, and the extent to which the international requirements will be modified to reflect local market characteristics. Should regulators in the region wish to introduce new margin requirements in time for the implementation date specified by the Basel Committee and IOSCO (December 2015), then we should expect developments in this area in 2014.

If regulators in the region follow the international framework then banks would be significantly impacted by the new variation and initial margin requirements. The international framework requires the exchange of variation margin on all new contracts entered into after 1 December 2015. To begin with, only the largest global market participants would be caught by the new initial margin requirements due to the phased approach which sees non-centrally cleared OTC derivative transactions (excluding physically settled foreign exchange forwards and swaps) between covered entities captured by the initial margin requirements from 1 December 2015 to where the group's aggregate month-end average notional amount of non-centrally cleared derivatives for June, July and August of 2015 exceeds €3.0 trillion. This threshold decreases over four years to €8 billion from 1 December 2019.

The Basel IOSCO framework permits market participants to use either standard percentages of notional value or advanced internal models approaches to calculate the amount of initial margin required to be exchanged with their counterparties. Where internal models are used, these must be approved by regulators. Quantitative analysis performed by the Basel Committee and IOSCO indicated that use of the standard percentages would result in initial margin requirements up to 11 times those calculated using internal models approaches. Clearly banks in the region which have existing internal model approvals would have a significant advantage over their peers if the international requirements are implemented in ASPAC in their current form.

Impact of US extra-territorial requirements

In July 2013, the US Commodity Futures Trading Commission (CFTC) released its final cross border guidance which has implications for non-US entities registered with the CFTC as swap dealers (of which there are a number in the ASPAC region), the ASPAC based branches of US based banks which are registered with the CFTC as swap dealers, any non-US entities in the region which are guaranteed by a US entity and, indirectly, any market participant in the region which enters into swaps with the aforementioned parties.

The guidance sets out the extent to which the various entity level, transaction level and non-registrant requirements apply to different types of transaction and the extent to which an entity directly impacted by these Dodd-Frank rules would be able to apply "substituted compliance" and follow local regulations rather than the Dodd-Frank requirement. "Substituted compliance" is the process by which the CFTC announced it is assessing the regulations of six jurisdictions where non-US entities had registered as swap dealers. Of these six jurisdictions, three are in the ASPAC region: Australia, Hong Kong and Japan. In December 2013 the CFTC released the initial results of its assessment of entity level controls, but with the exception of some aspects of the Japanese regulations, it has yet to issue its assessment on transaction level requirements. The outcome of the CFTC's assessment of transaction level requirements in Australia, Hong Kong and Japan is being watched closely by branches of US banks located in those jurisdictions as it will determine whether swaps undertaken by those branches with non-US persons need to be subject to the Dodd-Frank requirements as well the local regulations. This will have an impact both on their costs of compliance, and also potentially their market position since many customers in the region may wish to avoid being indirectly subject to the US regulations.

Branches of US banks located in other ASPAC jurisdictions (including Singapore) have been able to enjoy an exemption, included within the CFTC's cross border guidance, which allows them to avoid having to follow the Dodd-Frank transaction level requirements for swaps with non-US persons, provided that the aggregate notional value of all their swaps in jurisdictions outside the six being assessed for substituted compliance is less than 5% of the aggregate notional value of all their swaps. It remains to be seen though whether or not branches located in Singapore will continue to enjoy this exemption once its application for substituted compliance has been assessed by the CFTC.

Apart from substituted compliance, another closely watched area is the extent to which CCPs in the region are granted Derivatives Clearing Organization (DCO) status by the CFTC. So far the Singapore CCP is the only CCP in the region to be granted this status, meaning that swaps which are subject to the Dodd-Frank transaction level requirements can be cleared through it. Another ASPAC CCP, the Japanese CCP, has applied for DCO status but this has not yet been granted. Whilst the CFTC also has the power to exempt clearing houses from the requirement to register as a DCO where they are subject to comparable regulation in their home country, it is not yet clear how such exemptions will be granted.

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COMPLIANCE REQUIREMENTS ADDRESSED IN THE CFTC'S CROSS BORDER GUIDANCE

First Category of Entity Level Requirements			
Capital Adequacy	Chief Compliance Officer	Risk Management	Some swap data record keeping

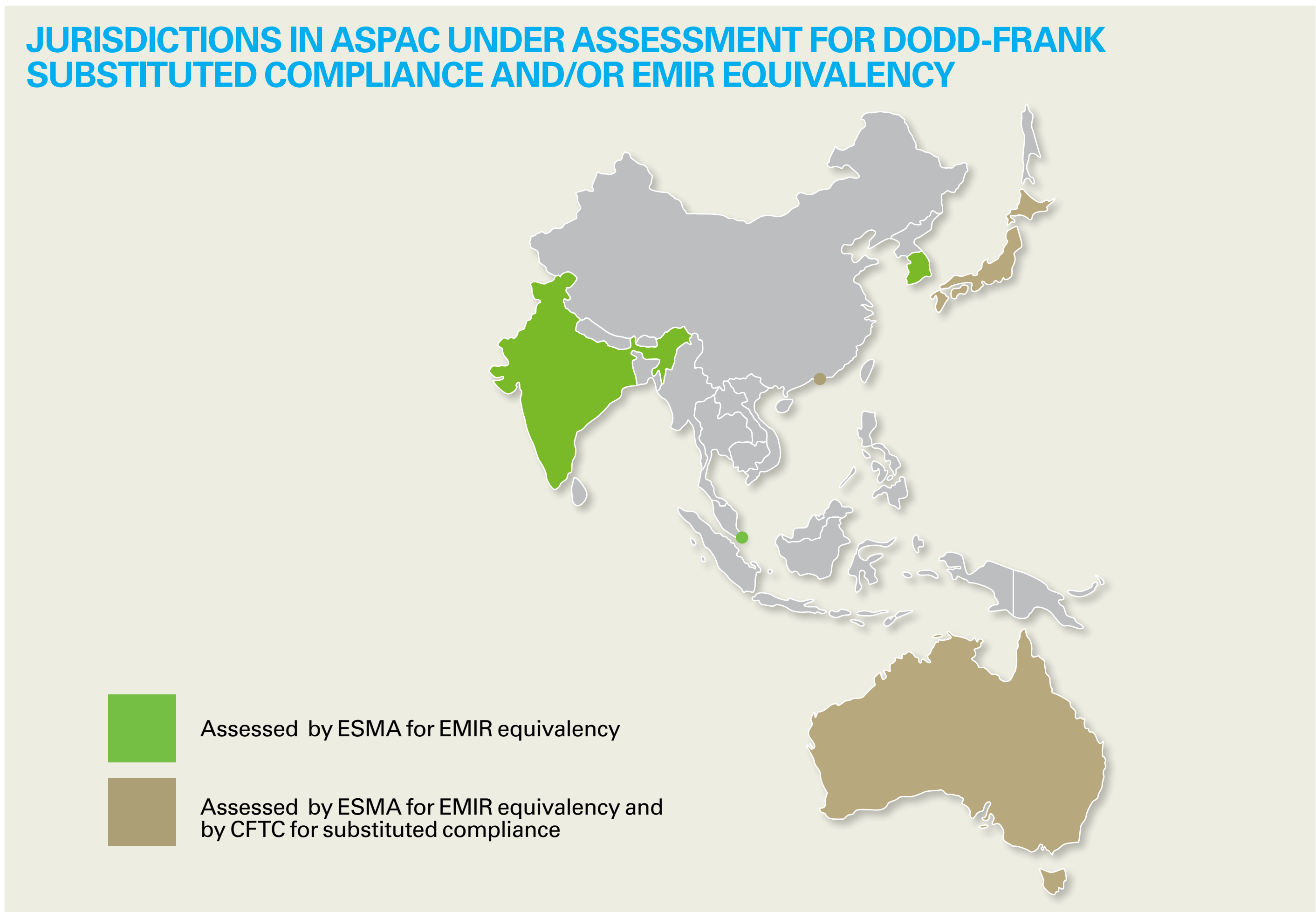
Second Category of Entity Level Requirements	
SDR Reporting	Certain aspects of swap data recordkeeping relating to complaints and marketing and sales materials

Category A Transaction-Level Requirements							
Clearing and swap processing	Margining and segregation for uncleared swaps	Trade Execution	Swap trading relationship documentation	Portfolio reconciliation and compression	Real-time public reporting	Trade confirmation	Daily trading records

Category B Transaction-Level Requirements
External Business Conduct Standards

Non-Registrant Requirements				
Clearing	Trade Execution	Real-time public reporting	Large Trader Reporting	SDR Reporting and swap data record keeping

JURISDICTIONS IN ASPAC UNDER ASSESSMENT FOR DODD-FRANK SUBSTITUTED COMPLIANCE AND/OR EMIR EQUIVALENCY



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Impact of EU extra-territorial requirements

In November 2013, the European Securities and Markets Authority (ESMA) issued draft technical standards under EMIR on contracts with a direct, substantial and foreseeable effect within the Union and non-evasion. The European Commission (EC) is expected to decide in February 2014 whether or not to approve these standards, which aim to prevent risks resulting from OTC derivative contracts entered into by counterparties outside of the EU being imported into the EU. The standards seek to prevent the evasion of the rules and obligations provided by EMIR and will apply to certain OTC derivative contracts entered into by third country entities from jurisdictions for which the EC has not declared regulatory equivalence. "Equivalency" is the EU equivalent of "substituted compliance" and the assessment currently underway by ESMA is being closely watched by banks in region, particularly those global banks which are headquartered in the EU and have branches in ASPAC.

Where a particular regime is not granted equivalency, branches of EU institutions located in that jurisdiction would need to comply with relevant EMIR regulations in addition to local requirements. Another outcome of equivalency which may have significant impact on branches of European institutions located in ASPAC is the assessment of clearing and reporting infrastructure in the region. In a series of initial equivalency determinations issued in September and October 2013, ESMA recommended that equivalency should only be granted to a number of CCPs in the region where they meet further additional conditions. If these CCPs do not meet the relevant criteria, branches of European institutions located in the region may find themselves unable to use local clearing houses. Further developments are expected in March 2014 when the EC plans to decide on whether or not to accept ESMA's recommendations on the equivalency of individual jurisdictions.

How banks in the region are responding to these challenges

Many banks in the region have devoted significant resources to tracking, understanding and implementing the raft of new requirements both from regulators in the region, and from the US and EU regulators. Mandatory reporting and clearing obligations are requiring banks to look again at their systems and processes to ensure that they can comply with the new requirements. A number of banks are planning changes to their current legal entity booking models in response to the changing regulations. However, the hard work is by no means over.

In 2014 a number of jurisdictions are expected to introduce new requirements over OTC derivative transactions. Market participants will need to assess the practical implications of these on their existing operating models. As a result of the new requirements, banks will likely need to review their existing agreements with counterparties, enhance trade capture processes, develop connectivity with trade repositories, perform cost benefit analysis in order to determine which CCPs to use and optimise their use of collateral in order to improve liquidity. We also expect to see further developments in US and EU regulations which will clarify the impact on market participants in this region, and may have far-reaching consequences for the business models of US and EU institutions operating in the region, with a knock-on impact on the market as a whole. New margin requirements in particular could have a major impact on existing business models but there is considerable uncertainty as to how they will implemented in ASPAC. As with so many other aspects of the global regulatory reforms currently underway, the winners will be those institutions which are able to chart a clear course through the current uncertainties, and emerge with effective operating models that are best able to serve clients in the region.

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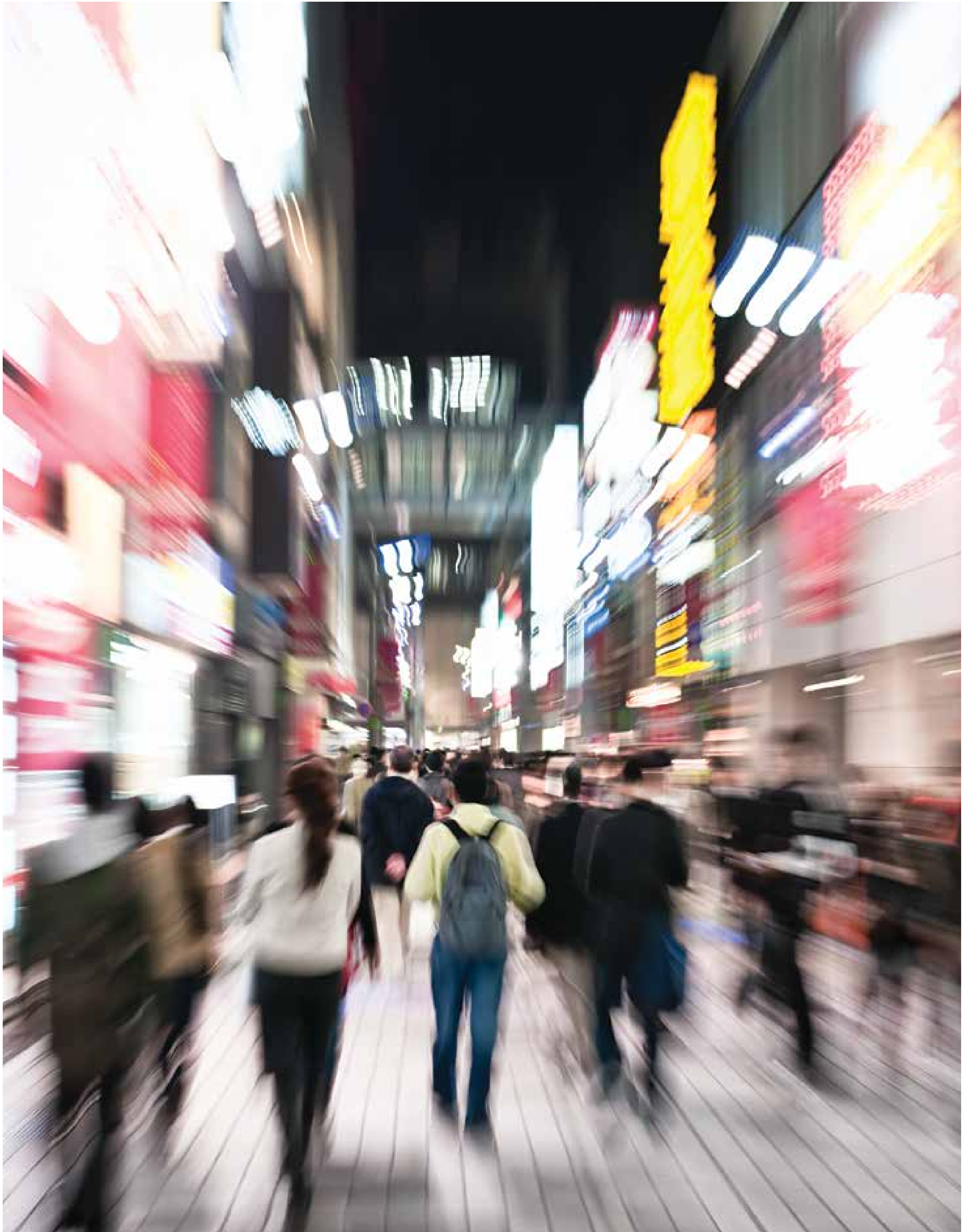

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