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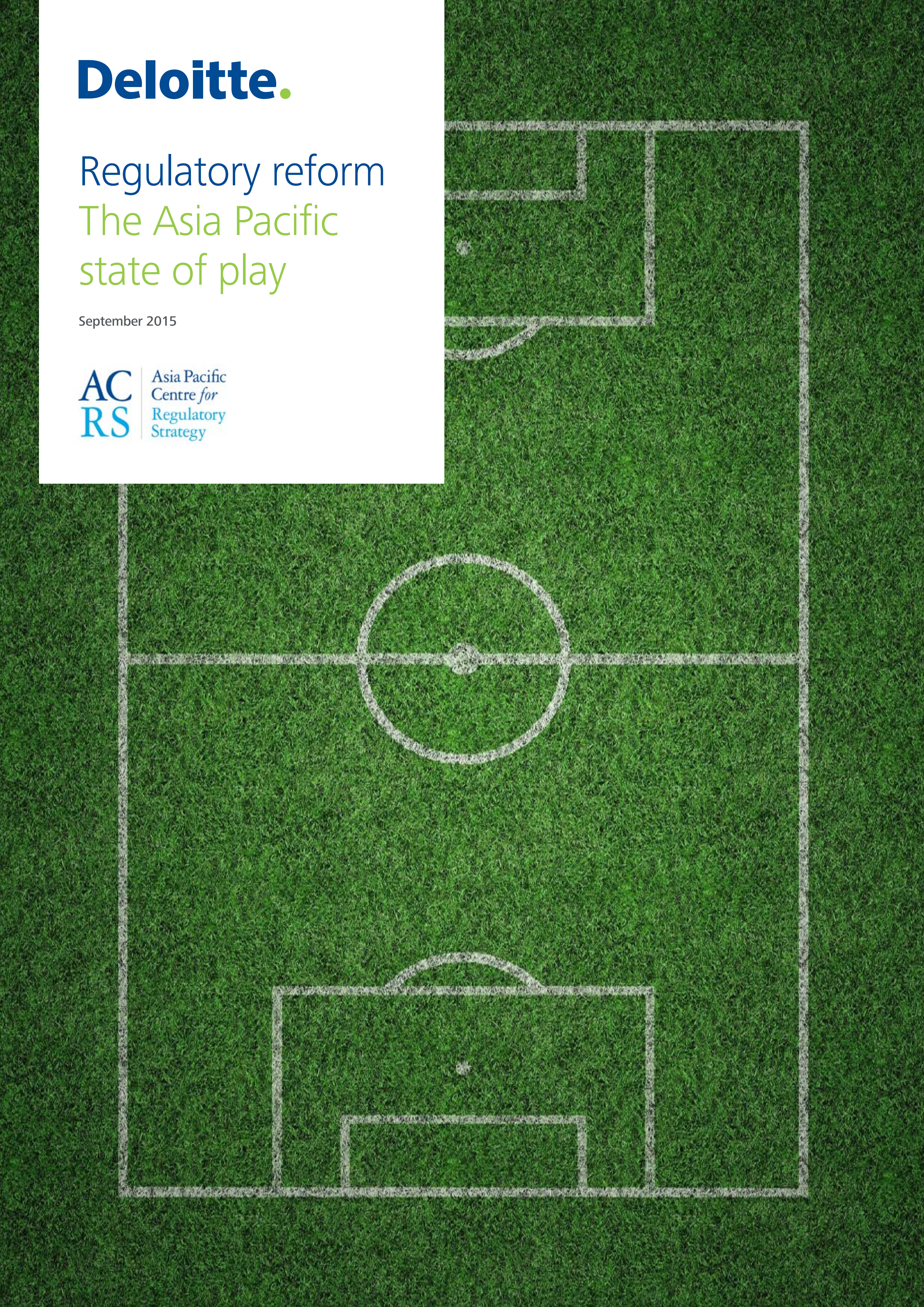
Regulatory reform
The Asia Pacific state of play

September 2015

Asia Pacific Centre *for* Regulatory Strategy



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Introduction

In the seven years since the onset of the financial crisis, regulation has emerged as a major strategic consideration for financial services firms. The reform agenda has fundamentally recast market structural parameters, such as those for banking services and over-the-counter (OTC) derivatives, and extended the regulatory perimeter to activities such as credit ratings and benchmarks.

While many reforms have been completed, our review of the current regulatory agenda indicates that it will remain full in coming years, particularly as existing standards are recalibrated or new topics of attention arise.

We see multiple regulatory initiatives that represent the ongoing development and implementation of key post-crisis reforms, recalibrations of existing standards (notably the revisions to certain Basel standards, which are increasingly termed 'Basel IV') or the emergence of new areas of intense international regulatory focus (particularly on conduct). We do not see diminution in this activity for the foreseeable future.

This paper briefly sets out the key elements of the current international reform agenda and highlights the application of these elements in the Asia Pacific region. It is organised around the major work-streams of the Financial Stability Board (FSB).

The major FSB work-streams:

- Building resilient financial institutions
- Ending too-big-to-fail
- OTC derivatives
- Transforming shadow banking into resilient market-based financing
- Conduct and wholesale markets

The international regulatory reform agenda

Building resilient financial institutions

Part 1 – Finishing Basel III

The raft of changes under 'Basel III' to the amount and quality of required bank capital, and the introduction of new liquidity and leverage requirements, have been the foremost regulatory response to the financial crisis.

However, Basel III is neither fully calibrated nor fully implemented. Outstanding policy decisions and implementation timelines include:

- The leverage ratio requirement is yet to be calibrated. Currently indicated at 3%, the final number may be higher. The requirement will impose a minimum ratio between a bank's tier 1 capital and its exposures[1]. Under the Basel Committee on Banking Supervision (BCBS) standard, bank reporting on this ratio commenced in 1 January 2013 (with public reporting starting on 1 January 2015). Using this data, the BCBS intends to calibrate the final requirement in 2015, with the ratio becoming mandatory on 1 January 2018
- The Liquidity Coverage Ratio (LCR), which requires banks to have high-quality liquid assets that can be converted into cash to meet liquidity needs for a 30-day liquidity stress scenario[2]. Under the BCBS standard, this requirement is to be phased in over the five-year period commencing 1 January 2015
- The Net Stable Funding Ratio (NSFR), which requires banks to maintain a stable funding position relative to their assets and off-balance sheet activities[3]. The NSFR supplements the LCR by looking at funding risk beyond the 30-day period covered by the LCR. The NSFR was finalised by the BCBS in October 2014 and is scheduled to become a minimum standard by 1 January 2018
- Basel III capital definitions and risk-weighted standards were scheduled to come into effect on 1 January 2013, and we now have policy implementation in all major jurisdictions[4]. On some aspects, there is a transition period until 1 January 2019. Uncertainty remains in individual jurisdictions on the counter-cyclical capital buffer, which is due to became a part of capital requirements from 1 January 2016.

Throughout the Asia Pacific region, the Basel III standards have been implemented on-time under the Basel schedule and, with transition periods minimised or removed, adoption across the region has largely been ahead of other major countries in the world.

Part 2 – Moving to Basel IV?

While Basel III is not yet fully implemented, we are already seeing proposed adjustments to Basel standards that are significant enough in combination for many commentators to refer to them as Basel IV[5].

The Basel IV package includes new standardised models, reducing the variance across banks using internal models, constraining parameter choices and outputs available to banks, and removing some of the discretion the current standards give to national supervisors[6]. These revisions will ultimately make internal modelling choices more aligned to standardised approaches, with a likelihood of further increases in the amount of capital that many banks need to hold.

Specifically, this package includes:

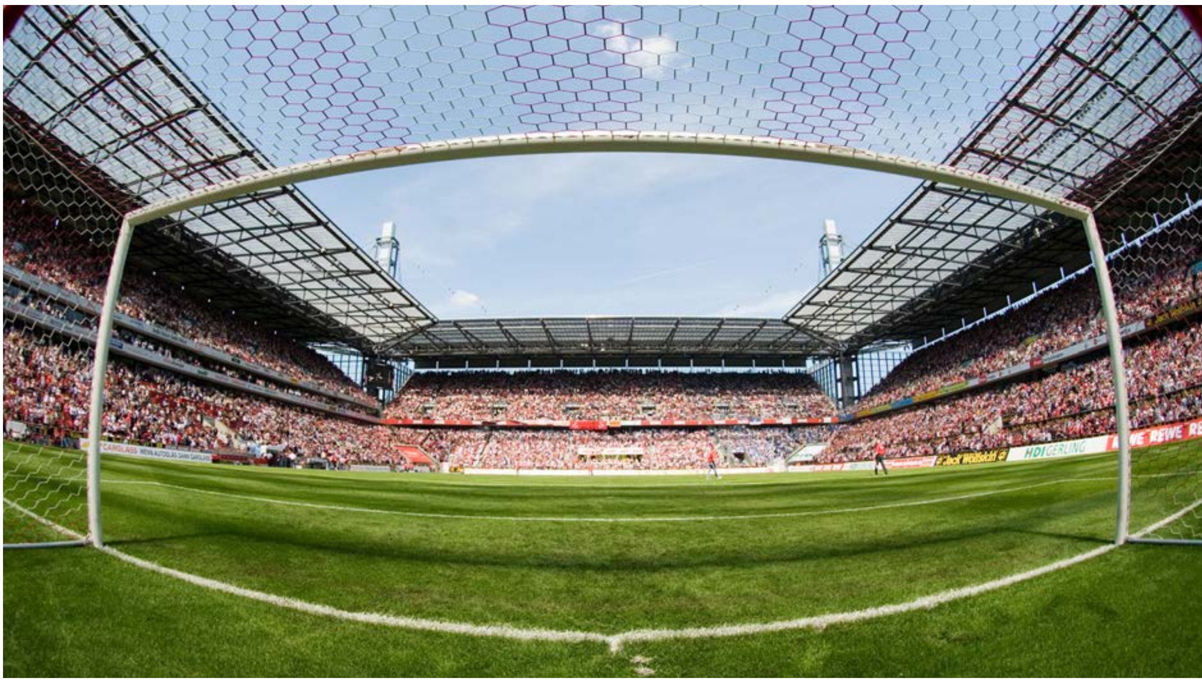
- New standardised models for credit risk, market risk and operational risk
- Proposed changes to credit risk modelling including the removal of reliance on external credit ratings, and the introduction of greater risk sensitivity through a multi-factor approach to assessing exposures. Although initial indications were for this work to be completed by the end of 2015, the challenging nature of the discussion will likely see this work extend well into 2016, if not beyond
- The Fundamental Review of the Trading Book (FRTB) seeks to reduce the potential for regulatory capital arbitrage between the banking book and trading book, revise the standardised approach to become a sensitivity-based approach and introduce a method for incorporating liquidity horizons in the internal model approach[7]. Although the intention early in 2015 was for this work to be completed this year, ongoing concern around the calibration of the framework has seen a fourth quantitative impact study launched to gather more data before finalisation
- Proposed changes to the standardised approach for operational risk, which seek to move away from gross income as the measure of risk to a 'business-indicator' approach[8]
- Capital floors for internal model outputs that will be based on the new standardised approaches[9]. The floors are designed to supplement the leverage ratio by ensuring that the level of capital held by banks does not fall below a yet-to-be-calibrated level. It will increase the amount of capital held for those banks for which the floor becomes binding, although the exact dimension is unclear until further information is available regarding the calibration
- Proposed revisions to the regulatory treatment of interest rate risk in the banking book, with the BCBS currently consulting on either a new Pillar 1 approach (i.e. no supervisory discretion) or a revised Pillar 2 approach (i.e. allowing supervisory discretion with more standardisation than currently applies[10])
- A review of the credit valuation adjustment risk framework to take into account the market risk exposure component of credit valuation adjustments along with its associated hedges[11]. This seeks to reduce variability arising from the calculations of risk-weighted assets.

Part 3 – Developing a global capital standard for insurers

While banks have been operating for decades under a global capital standard through the Basel framework, there is currently no equivalent standard for insurers. The International Association of Insurance Supervisors (IAIS) has launched a program of work to develop such a global standard, known as the Insurance Capital Standard (ICS). Work has been underway since 2010 to develop a Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The ICS initiative was launched in 2013 and now forms part of ongoing ComFrame development[12]. Next key events in the process will be a second ICS consultation, and further field testing, both scheduled for mid-2016.

Part 4 – Asset management under consideration

Recent discussion of regulation of asset managers has been dominated by whether some asset managers should be designated for additional regulation, as has already been the case for banks and insurers (see next section). However, what has received little coverage to date is that the FSB has established, as a priority, the investigation of the need for additional regulation of asset management activities. In July 2015 the FSB confirmed that work is ongoing in relation to financial stability risks from asset management activities. This work will 'evaluate the role that existing or additional activity-based policy measures could play in mitigating potential risks, and make policy recommendations as necessary[13]'. The current timeline is for the FSB to report to the G20 on its initial findings and, where policy development is deemed necessary, such policy recommendations will be produced by the northern spring of 2016. The debate around resilience to date has been focused on redemption runs, although the nature and scope, if any, of future policy work will become clearer later in 2015.



Ending too-big-to-fail

Supplementing the initiatives on making financial institutions more resilient has been the work on ending too-big-to-fail.

This work has centred on identifying systemically important financial institutions (SIFIs) and introducing measures targeted at these institutions with the goal of ensuring any financial institution can fail without creating a systemic impact or recourse to taxpayer funds. Underpinning this work is the FSB's SIFI framework[14]. This framework seeks to have SIFIs that are globally important (G-SIFIs) more able to absorb losses and be subject to resolution planning ('living wills').

To date, 30 banks have been designated as globally-systemically important banks (G-SIBs). These banks will be subject to higher loss absorbency requirements, ranging from 1% to 2.5% of risk-weighted assets, from January 2016 (with full implementation by January 2019). Nine globally-systemically important insurers (G-SIIs) have also been identified.

Looking ahead, much work remains to be done:

- At the end of 2014, the FSB published a proposal for G-SIBs to have minimum levels of total loss-absorbing capacity (TLAC[15]). This will be finalised in advance of the 2015 G20 Leaders' Summit in November
- The amount of TLAC will be determined via cross-border supervisory oversight. This oversight process is also assessing resolvability of G-SIBs. The FSB is doing further work on the cross-border recognition of resolution actions
- Work is well underway on establishing Higher Loss Absorbency (HLA) for G-SIIs
- Due to the increased role of central counterparties (CCPs) in the OTC derivative market (see below) there is a work plan to promote the resilience, recovery planning and resolvability of CCPs
- The FSB is keen to ensure that there is full domestic implementation of the Key Attributes of Effective Resolution Regimes for Financial Institutions[16]. It will conduct a peer review of its member jurisdictions through 2015[17]
- Work on the identification methodology for non-bank, non-insurer SIFIs is currently on-hold[18]. This work could have affected the world's large asset managers. This reflects concerns about the appropriateness of applying the SIFI framework to these types of entities.

While Asia Pacific jurisdictions, as with all reforms, are expected to implement agreed international standards, the appropriateness of the ending too-big-to-fail proposals to this region has seen concerns arise around the extent of global reforms. For example, it is likely that the final TLAC standards will contain an extended implementation timeline for Chinese banks and the ability to use pre-funded national resolution schemes, such as established in Japan. Such inclusions allow jurisdictions to remain compliant with the global agreements, while providing for different implementation.

OTC derivatives

G20 members agreed in 2009 that by the end of 2012:

- All OTC derivatives should be reported to trade repositories
- All standardised contracts should be traded on exchanges or platforms, where appropriate, and cleared through CCPs
- Non-centrally cleared contracts should be subject to higher capital and margin requirements.

While the G20 originally intended to achieve these outcomes by end-2012, as of mid-2015, a substantial amount of implementation remains to be done[19], complicated by extra-territoriality, inconsistencies, and ongoing policy finalisation.

Specifically, while many jurisdictions, including those in the Asia Pacific region, have implemented or are in the process of implementing the reporting requirement, there is patchy implementation at best on mandatory central clearing and platform/exchange trading.

Rule-making in Asia Pacific has been complicated by continuing disparities between the implementation of these reforms in the major markets of the US and EU, which until resolved make it difficult for others to finalise their rules.

Further, the timetable for the margining of non-cleared derivatives has been pushed back from its original end-2015 start date to September 2016. It will then be phased in over a five-year period.

We expect to see further international work conducted on the harmonisation of trade reporting requirements, with a view to allow the global aggregation of trade data. There is also further work needed at the national level to ensure harmonious cross-border application of domestic rules, including an effective framework of mutual recognition and/or substituted compliance.

Extra-territoriality in the OTC derivatives space has proved extremely challenging from an implementation and compliance perspective, and as a result has seen fragmentation of previously integrated markets, including in the Asia Pacific region. Recent studies from the International Swaps and Derivatives Association (ISDA) have concluded that 'global derivatives markets have fragmented along geographic lines[20]'.

Hong Kong

- Trade reporting – framework is in place but full reporting not scheduled to start until H2 2016
- Consultation on clearing expected for Q3 2015 with a clearing requirement to commence in H2 2016
- Consultation on margin requirements for non-cleared transactions expected in Q3 2015
- Further study will occur in 2016 on mandatory trading.

Japan

- Reporting is fully implemented
- The clearing obligation will be expanded to capture further entities in H1 2016
- Intent to adopt margin rules in accordance with international timetable
- Mandatory trading of a subset of yen-denominated interest rate swaps will commence in Q3 2015.

OTC derivatives - Asia Pacific impact[21]

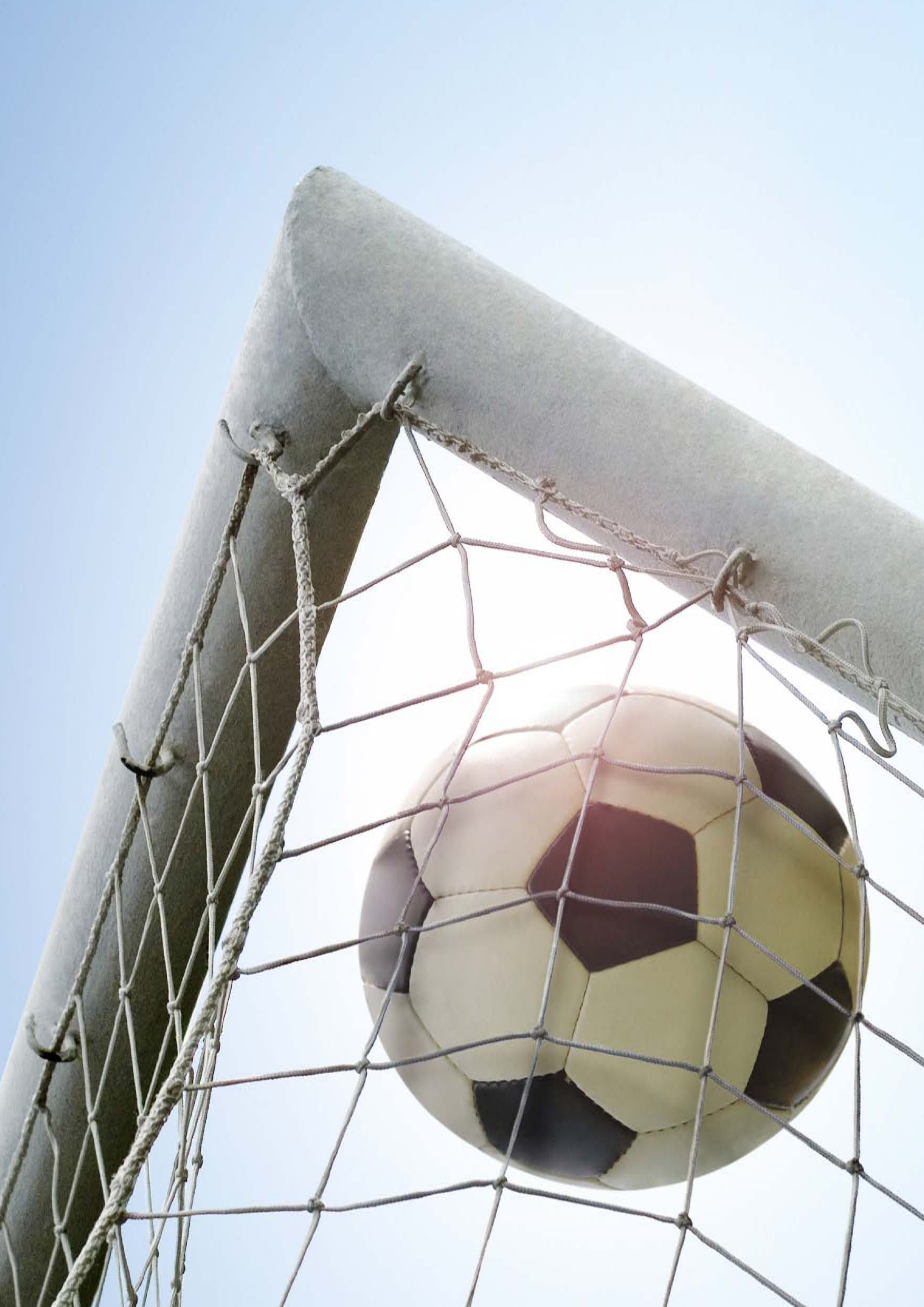
The following table demonstrates that while jurisdictions in Asia Pacific continue to implement policies in line with G20 commitments, varying timelines will see full implementation extend beyond 2016.

Australia

- Reporting requirements will be fully implemented in Q4 2015
- Clearing obligation on major interest rate swaps currently in development (expected to come into effect H12016)
- Consultation on margin requirements for non-cleared transactions expected in H1 2016
- Australia will issue its next assessment of trading appropriateness in Q4 2015.

Singapore

- Reporting of FX trades started in Q2 2015, with other asset classes reporting in H12016
- Clearing requirement expected to commence in Q4 2015
- Consultation on margin requirements for non-cleared transactions expected in Q3 2015
- Legislation for mandatory trading may be effective in H2 2016.



Transforming shadow banking into resilient market-based financing

Shadow banking refers to credit intermediation that occurs outside the regulated banking sector. As Basel III has increased the cost of banking activity, there is the fear among regulators that risky activities could migrate to less regulated parts of the market (e.g. the capital markets, asset managers, new non-bank entrants).

Led by the FSB, a range of work has sought to identify and mitigate any risks with shadow banking[22]. Through 2015 and beyond, much of the focus is now on assessing the implementation of existing reforms, for example concerning money market funds and other shadow banking activities, and data collection to understand the sector.

Conduct and wholesale markets

2015 has seen the emergence of conduct as a key issue on the FSB's agenda. The FSB perceives that poor conduct in the financial system could reach a level that it poses a threat to systemic stability.

To date, the FSB has focused much of its attention concerning conduct on interest rate and foreign exchange benchmarks. This work, started in 2014, has seen and will see changes to the major FX[23] and interest rate benchmarks[24], including the shift from existing inter-bank offer rates to more transaction-based rates and risk-free rates (to completed by 2016[25]).

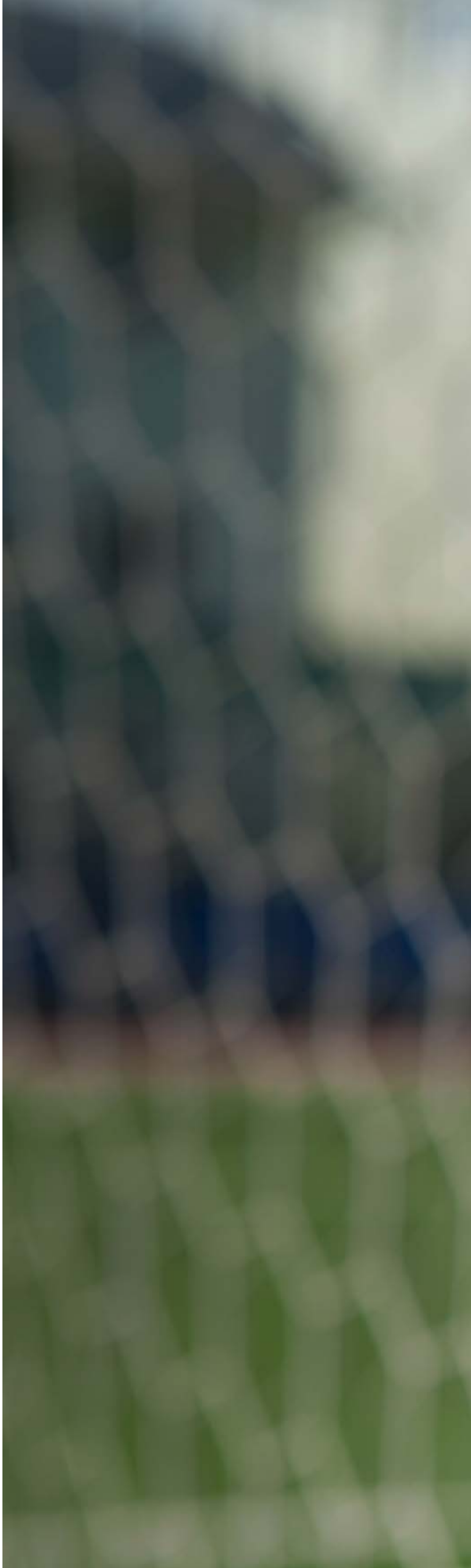
Looking ahead, the key international policy work-streams on conduct are those that have been recommended by the United Kingdom's Fair and Effective Markets Review (FEMR[26]). These will see the Bank for International Settlements prepare a code of conduct for the spot foreign exchange markets and International Organization of Securities Commissions (IOSCO) development standards for the fixed income, currency and commodity (FICC) markets more broadly[27]. Within the UK, the key impact of FEMR is the recommended extension of the senior managers and certification regime to a broader group of FICC market participants.

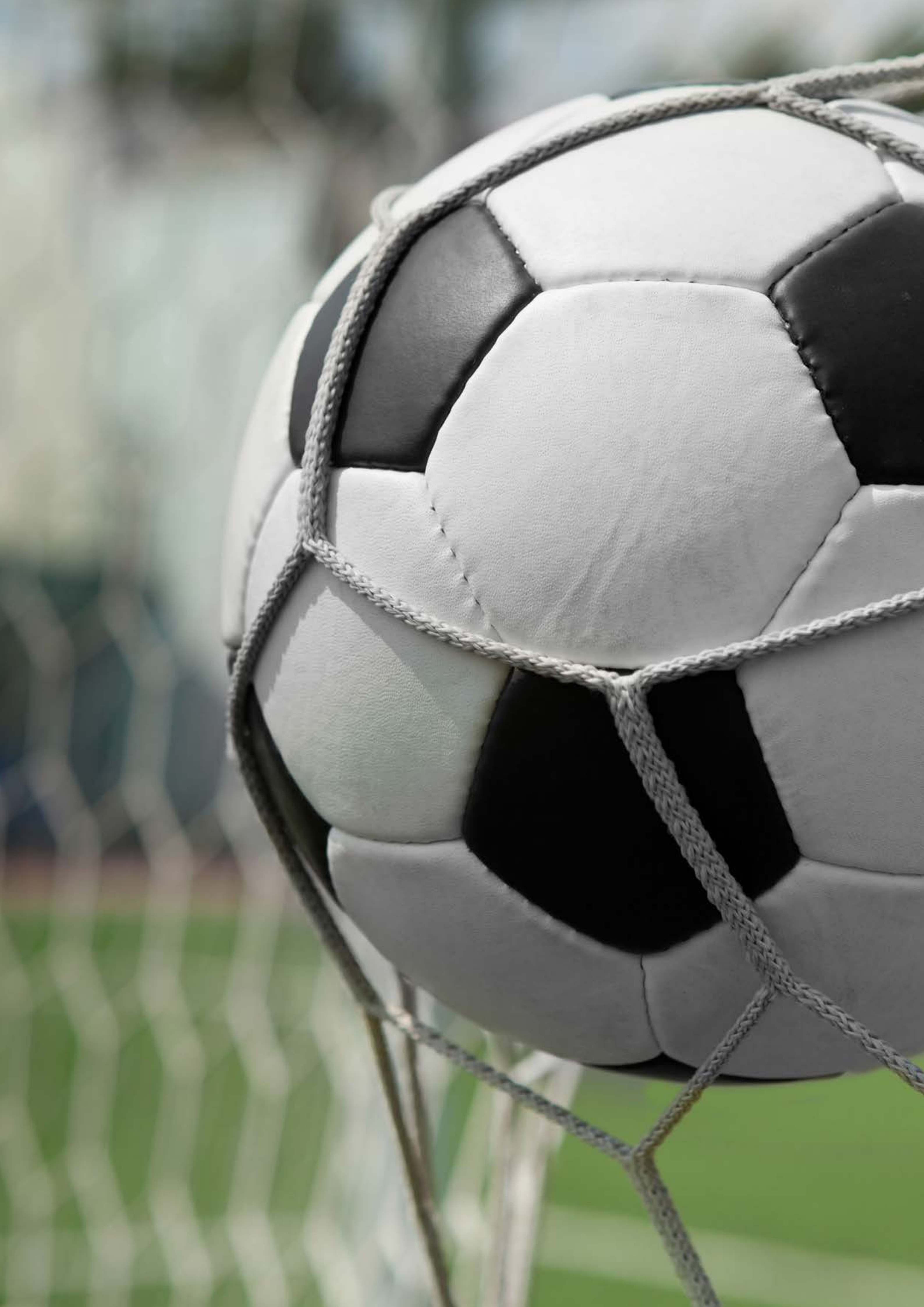
While the UK is seen to be leading this work internationally, the intentions of Asia Pacific regulators are aligned with these efforts. Fines have already been levied and actions taken in the region. Indications are that policy actions will likely follow the same direction.

Conclusion

Clearly, there is still substantial international reform in play that will impact business strategy, and with no sign of slowing down, regulators and organisations in Asia Pacific have a complicated task ahead of them. Each framework (Basel III and IV, ending too-big-to-fail, OTC derivatives, shadow banking, and conduct and wholesale markets reforms) brings a unique set of challenges, especially for organisations that operate across multiple jurisdictions.

Organisations need to monitor global and local developments as they look to design and invest in their business strategy, as managing the combination of regulatory reforms will be particularly challenging. However, firms that effectively integrate the regulatory outlook into their strategic thinking can achieve a strategy that is fit for purpose, now and in the future.





Endnotes

[1]Basel Committee on Banking Supervision Basel III Leverage Ratio Framework and Disclosure Requirements (January 2014); available at: http://www.bis.org/publ/bcbs270.pdf

[2]Basel Committee on Banking Supervision Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools (January 2013); available at: http://www.bis.org/publ/bcbs238.pdf

[3]Basel Committee on Banking Supervision Basel III: The Net Stable Funding Ratio (October 2014), 1; available at: http://www.bis.org/bcbs/publ/d295.pdf

[4]See Basel Committee on Banking Supervision Eight Progress Report on Adoption of the Basel Regulatory Framework (April 2015); available at: http://www.bis.org/bcbs/publ/d318.pdf

[5]It should be noted that at the time of writing the official sector is still not using the term "Basel IV", however the term is seeing increasing common usage among the industry, press, and academics

[6]See Basel Committee on Banking Supervision Reducing Excessive Variability in Banks' Regulatory Capital Ratios: A Report to the G20 (November 2014); available at: http://www.bis.org/bcbs/publ/d298.pdf

[7]Basel Committee on Banking Supervision Consultative Document: Fundamental Review of the Trading Book: Outstanding Issues (December 2014); available at: http://www.bis.org/bcbs/publ/d305.pdf

[8]Basel Committee on Banking Supervision Consultative Document: Standards: Operational Risk – Revisions to the Simpler Approaches (October 2014); available at: http://www.bis.org/publ/bcbs291.pdf

[9]Basel Committee on Banking Supervision Consultative Document: Standards: Capital Floors: The Design of a Framework Based on Standardised Approaches (December 2014); available at: http://www.bis.org/bcbs/publ/d306.pdf

[10]Basel Committee on Banking Supervision Consultative Document: Interest Rate Risk in the Banking Book (June 2015); available at: http://www.bis.org/bcbs/publ/d319.pdf

[11]Basel Committee on Banking Supervision Consultative Document: Review of the Credit Valuation Adjustment Risk Framework (July 2015); available at: http://www.bis.org/bcbs/publ/d325.pdf

[12]The IAIS have established a ComFrame homepage gathering all related documents at http://iaisweb.org/index.cfm?event=getPage&nodeId=25229

[13]Financial Stability Board Next Steps on the Assessment Methodologies for Non-Bank Non-Insurer Global Systemically Important Financial Institutions: (Press Release 47/201 30 July 2015); http://www.financialstabilityboard.org/wp-content/uploads/NBNI-G-SIFI-Next-Steps-Press-Release.pdf

[14]Financial Stability Board Reducing the Moral Hazard Posed by Systemically Important Financial Institutions (November 2010)

[15]Financial Stability Board Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution Consultative Document (November 2014); available at: http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf

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[17]Financial Stability Board Second Thematic Peer Review on Resolution Regimes http://www.financialstabilityboard.org/wp-content/uploads/Peer-Review-on-Resolution-Regimes-abbreviated-TOR-for-public-feedback.pdf

[18]Financial Stability Board Next Steps on the Assessment Methodologies for Non-Bank Non-Insurer Global Systemically Important Financial Institutions (NBNI G-SIFIs) (Press Release 47/2015 30 July 2015); available at: http://www.financialstabilityboard.org/wp-content/uploads/NBNI-G-SIFI-Next-Steps-Press-Release.pdf

[19]See this report for an overview of the current state of implementation of the G20 reforms: Financial Stability Board OTC Derivatives Market Reforms Ninth Progress Report on Implementation (24 July 2015); available at: http://www.financialstabilityboard.org/wp-content/uploads/OTC-Derivatives-Ninth-July-2015-Progress-Report.pdf

[20]Cross-Border Fragmentation of Global Derivatives: End-Year 2014 Update, ISDA Research Note (April 2015): http://www2.isda.org/attachment/NzUzMQ==/Market%20fragmentation%20FINAL.pdf

[21]The details in this table are drawn from Financial Stability Board (see 19 above)

[22]Financial Stability Board Transforming Shadow Banking into Resilient Market-based Financing An Overview of Progress and a Roadmap for 2015 (14 November 2014); available at: http://www.financialstabilityboard.org/wp-content/uploads/Progress-Report-on-Transforming-Shadow-Banking-into-Resilient-Market-Based-Financing.pdf

[23]Financial Stability Board Foreign Exchange Benchmarks Final Report (30 September 2014); available at: http://www.financialstabilityboard.org/wp-content/uploads/r_140930.pdf

[24]Financial Stability Board Reforming Major Interest Rate Benchmarks (22 July 2014); available at: http://www.financialstabilityboard.org/wp-content/uploads/r_140722.pdf

[25]Financial Stability Board Progress in Reforming Major Interest Rate Benchmarks Interim report on implementation of July 2014 FSB recommendations (9 July 2015); available at: http://www.financialstabilityboard.org/wp-content/uploads/OSSG-interest-rate-benchmarks-progress-report-July-2015.pdf

[26]Bank of England Fair and Effective Markets Review Final Report (June 2015); available at: http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf

[27]See Bank for International Settlements Foreign Exchange Working Group (Press Release 24 July 2015); available at: http://www.bis.org/about/factmktc/fxwg.htm

Asia Pacific Centre for Regulatory Strategy

About the Centre

Through regular dialogue with regulators and financial institutions across the region, and in collaboration with Deloitte's global network, including its existing Centres in EMEA and the U.S., the Deloitte Asia Pacific Centre for Regulatory Strategy provides clients with critical insights and advice on managing the aggregate impact of regional and international regulatory policy.

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