Introduction to:
Making Sense of Financial Services Regulation

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About the Melbourne GARP chapter

- Aim to foster dialogue amongst risk professionals in Melbourne
- The role Risk Management played leading up to the GFC
- Implications for Risk Management since the GFC
- Speakers and other support always needed!
- Stay tuned for our next meeting…
- Contact me on: m.vandegraaf@tcv.vic.gov.au
The case FOR regulation

- A read from the ‘distant past’ – remember the Turner Review (FSA, March 2009) post GFC…

- Drivers of the GFC

- Macro imbalance between sovereign balance sheets

- Structurally sustained low interest rates

- Complexity in Financial Derivatives

- High leverage in trading books and shadow banking entities

- Pro-cyclicality in (poorly designed/tested) VaR/Capital models

- Self-reinforcing ‘irrational exuberance’ followed by collapse in confidence
Where we are now – Macro picture

Volatility Index (VIX) is back to pre-crisis levels

‘Risk-free’ rates have increased but are still well below pre-crisis levels
Political and regulatory response

- Basel 3 Capital and Liquidity at target levels a decade post crisis
- Centralised clearing for AUD IRD and mutual recognition, in 2014?
- Financial System Inquiry – report due November 2014
- Prime Minister’s “Cut Red Tape”: reduce compliance (cost) for financial advisers and the broader financial services industry
  - “We believe Financial Planners have learnt from their mistakes, therefore there is no need to regulate planners working in the best interest of their clients.”
  - vs: “The name of the game, moving the money from the client’s pocket into your pocket.” (Wolf of Wall Street)
Next Up

Jim Power
Partner Financial Services
PwC

Interactive presentation

Networking event afterwards
Making Sense of Regulatory Change

Jim Power
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Global Association of Risk Professionals

June, 2014
Overview

Jim Power is a Financial Services Partner at PricewaterhouseCoopers. He has significant experience in the implementation of regulatory reforms impacting the Banking sector. He is a Fellow of both the Institute of Chartered Accountants and the Finance and Treasury Association.
Overview

**Agenda**

Hypothesis

The GFC and its regulatory response (with specific focus on traded markets)

Regulatory and related responses – context and issues arising

- OTC Derivatives reforms
- Volcker
- Fundamental Review of the Trading Bank
- Risk Culture and Market Conduct
- Joining the Dots
- Conclusion - What does this all mean for Risk Professionals?
2. GFC In a Nutshell

**Economic Background**

- Period of Great Moderation prior to September 2008 – years of stable inflation and growth increasing propensity for risk taking, creating fertile market for innovative financial engineering to enhance returns
  - Savings glut in Asia pushed down global interest rates
  - European banks borrowing on US money market to invest in high risk US Securities

**Regulatory Background**

- Regulatory reform from the mid 1990’s allowed banks to use *internal models* to measure risk and required capital resulting in Banks’ Balance Sheets ballooning without a commensurate increase in capital
- Due to the loosely defined definition of regulatory capital, banks increasingly used innovative capital instruments which did not have the same loss absorbency capacity as equity
- Ballooning largely unregulated OTC market requiring trust between counterparties in the financial ecosystem to operate effectively
- Blurring of trading/banking book boundaries
Complex inter-related structure of Financial Markets Regulation

International regulatory layer further complicated by multiple national regulatory equivalents.

Source: Sloan and Fitzpatrick, Financial Markets and Exchanges Law
OTC Derivatives reforms

In September 2009, G20 Leaders agreed in Pittsburgh to a series of reforms in relation to OTC derivatives. These vary from jurisdiction to jurisdiction.

Perhaps the biggest issue is the need to report trade data to Trade Repositories in real-time.

**Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")**

“Title VII – Wall Street Transparency and Accountability” of the bill addresses reforms and significant changes to the OTC Derivatives markets, including increased prudential regulation and oversight, mandated clearing and margining and increased reporting requirements.

Key aspects of the Reform:

- Registration of entities engaged in swap activity with the CFTC and/or the SEC and as a US ‘Swap Dealer’ or ‘Major Swap Participant’ (MSP)
- Real-time Swap Data Reporting and Reporting of swap transaction and pricing data
- New Internal and External Business Conduct requirements (ie policies, procedures, etc) for Swap Dealers and MSPs
- Mandatory Clearing through regulated central clearing organisations
- Mandatory trading through regulated exchanges or Swap Execution Facilities (SEFs), in each case, subject to certain key exceptions
- Capital and margin requirements for non-bank Swap Dealers and MSPs
- Position Limits and Swap Large Trader Reporting
OTC Derivatives reforms

EU – European Markets and Infrastructure Regulation (EMIR) and Markets in Financial Instruments Directive (MiFID II)

- EMIR provides for equivalent regulatory response across the EU members however, whilst the purpose is similar, there are differences in the legislation, eg EMIR excludes some products, has volume thresholds before an entity is subject to mandatory clearing and both counterparties must report counterparty data.

- MiFID II focuses on moving eligible derivative contracts onto regulated platforms and increasing market transparency.

Australia

- In January 2013 amendments to the Australian Corporations Act took effect that provide for the imposition of mandatory requirements in respect of trade reporting, central clearing and platform trading of OTC derivatives.

BIS

- BIS Basel III rules came into effect on 1 January 2013 setting higher capital requirements for bilateral derivatives transactions providing an incentive for financial institutions to clear through qualifying CCP’s.

- The BIS released the final “Capital Requirements for bank exposures to central counterparties” in April 2014 which also included punitive measures for the use of non-qualifying CCPS with an implementation timeframe of 1 January 2017.
## OTC Derivatives Market Reforms in key financial markets

**Differences in OTC Derivatives Market Reform - implementation timeframes in key financial markets.**

<table>
<thead>
<tr>
<th>Q1 2013</th>
<th>Q2 2013</th>
<th>Q3 2013</th>
<th>Q4 2013</th>
<th>Q1 2014</th>
<th>Q2 2014</th>
<th>Q3 2014</th>
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<tbody>
<tr>
<td>SEC: Operations and risk management of CCPs.</td>
<td>CFTC: Clearing required for commodity pools and private funds of IRS and CDS</td>
<td>EU: CCP re-authorisation process concluded.</td>
<td>EU: clearing obligations determined</td>
<td>EU: central clearing regulatory technical standards adopted.</td>
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<tr>
<td>CFTC: Clearing required by dealers of IRS and CDS.</td>
<td>CFTC: Platforms, TRs, and dealers began public and regulatory reporting.</td>
<td>Japan: Reporting requirements to begin.</td>
<td>Australia: Reporting requirements begin on an opt-in basis.</td>
<td>Australia: Reporting requirements for Major financial institutions</td>
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<tr>
<td></td>
<td></td>
<td>CFTC: Financial entities reporting to TRs.</td>
<td>HK: Reporting of IRS and NDFS by Certain entities.</td>
<td>EU: Reporting of all asset classes to TRs</td>
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<tr>
<td></td>
<td></td>
<td>Singapore: reporting requirements to begin.</td>
<td>Singapore: reporting requirements to begin.</td>
<td>Australia: Reporting Requirements begin for other financial institutions</td>
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<td></td>
<td></td>
<td>CFTC: All non-financial entities reporting to TRs.</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>EU: IRS and CDS TRs recognition procedure begins. Confirmation and valuation requirements</td>
<td>EU: Portfolio compression and reconciliation and dispute resolution requirements effective.</td>
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</table>
As a higher proportion of trading is cleared across CCPs, more and more credit, liquidity and operational risk will be concentrated in these institutions, which will themselves become potential sources of systemic risk.

Pre OTC Reform

Post OTC Reform
Inconsistent timeframes between jurisdictions
- Implementation timeframes and scope in major jurisdictions vary significantly

Uptake of CCPs by financial institutions
- In G15 jurisdictions where CCP's are in place as at June 2013, only 40% of products available for central clearing are being cleared. (Source: FSB OTC Derivatives Market Reforms: 6th Progress Report)

Regulatory reform consistency
- Although the majority of G15 jurisdictions have adopted regulations incentivising the use of CCP's the majority do not currently mandate the use of CCPs, which may not be sufficient to drive the widespread use of CCP's to clear standard contracts. (Source: FSB OTC Derivatives Market Reforms: 6th Progress Report)

Migration and global consistency
- Country regulators are under pressure to favour their own jurisdictions at the expense of making CCPs more competitive and inclusive internationally, resulting in free movement of funds and ample risk diversification
- Australian Trade Repository Solution not yet resolved

Collateral
- The requirement to post specific high quality collateral will necessitate increased focus within the financial system to manage day to day liquidity requirements
Volcker Rule background

- The US Regulators (Fed, FDIC, OCC, CFTC and SEC) released the final rule for Volcker on December 10, 2013. Section 619 of Dodd-Frank created new section 13 of the US Bank Holding Company Act (BHCA) which prohibits (unless an exemption is available) a “banking entity” from:
  - Proprietary trading in securities, derivatives and other instruments
  - Investing in and sponsoring private equity and hedge funds (covered funds)
- The final rule became effective on 1 April 2014
- The conformance period has been extended by one year until 21 July 2015
- The reporting threshold was increased to institutions with more than $10 billion in trading assets

General timeline:

- **12/10/13** Final Rule Release
- **4/01/14** Final Rule becomes effective
- **6/30/14** Begin reporting metrics for largest banking entities with US trading A/L >$50b
- **7/21/15** Conformance Period extension ends (subject to 2 additional extensions of 1 year each)
- **9/30/15** Regulators will review metrics and refine strategy
- **12/31/16** Begin reporting metrics and enhanced compliance for banking entities with less than $25b and greater than or equal to $10b in trading assets and liabilities
Volcker Rule compliance

- Requirement to report the following **seven metrics** (reduced from 17 under the proposed rule) at a **Trading Unit (e.g. desk / book) level** on a monthly or quarterly basis, but calculated daily:
  - Risk and position limits and usage
  - Risk factor sensitivities
  - Value-at-Risk and Stress VaR
  - Comprehensive profit and loss attribution
  - Inventory turnover
  - Inventory ageing; and
  - Customer facing trade ratio

- To qualify for the Foreign Banking Entity Exemption, prescriptive criteria must be met including certain personnel not being located in the US, and the transaction not being accounted for or financed from the US

- A standard or enhanced compliance program must be established
Volcker Rule challenges

- Definition of a trading desk
  - Business lines need to break down their activities into trading desks for purposes of reporting quantitative measures and adhering to permitted activity exemption requirements. This is subjective and there is a balance between minimising compliance obligations by limiting in-scope Volcker activities vs minimising disruption to BAU processes, e.g. Market Risk, as limits need to be set at the trading desk level.

- Determining the cost vs benefits of reorganisation of trading desk
  - This is particularly important for Australian banks as this will impact their ability to apply the Foreign Banking Entity Exemption (“FBE”). The compliance burden of FBE is considerably lower than Volcker permissible activities such as market-making, therefore it is an Australian bank’s interest to maximise the number of trading desks that meet the FBE exemption.

- Determination of compliance scope
  - The final rule is not rules-based and requires some internal judgement. As such banks will need to determine their compliance scope, e.g. what should be included in the measurement of US trading assets and liabilities for determining metrics requirements. Availability of SOTUS (foreign bank exemption) needs careful attention.

- Identifying allowable risk mitigation
  - The final Volcker Rule permits hedging of individual and aggregate risk. The identification and matching of allowable hedging positions in practice may prove to be complex and resource intensive.

- Compliance requirements
  - Although the number and application of metric reporting have been scaled back in the final rule, assessing the impact of the rule, establishing a compliance program and building capability to report metrics will be costly and resource intensive for in-scope institutions.

- Guidance status
  - Ambiguities still exist and will inevitably take time to resolve.
## A Snapshot of the Final Volcker Rule

### Volcker Rule:

<table>
<thead>
<tr>
<th>Prohibitions and Restrictions on:</th>
<th>Proprietary Trading</th>
<th>Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicable to:</td>
<td>Covered Trading Activities</td>
<td>Sponsorship of, Investment in, or Transactions with Covered Funds Are Restricted</td>
</tr>
<tr>
<td>Key Regulatory Terms:</td>
<td>Proprietary Trading; Trading Account; Trading Desk; Financial Instrument</td>
<td>Covered Fund; Ownership Interest; Sponsor; Trustee; Restricted Profit Interest; Prime Brokerage</td>
</tr>
<tr>
<td>Permitted Activities:</td>
<td>Underwriting Activities; Market Making-Related Activities; Risk-Mitigating Hedging Activities; Trading in Domestic and Foreign Government Obligations; Trading on Behalf of Customers; Trading by a Regulated Insurance Company; Trading Activities of Foreign Banking Entities</td>
<td>Organizing and Offering of a Covered Fund Subject to Single Fund and Aggregate Fund Investment Limits; Permitted Activities — SBICs, Risk-Mitigating Hedging, Investments Solely Outside of the U.S.; Exceptions for BOLI Separate Accounts and Different Types of Corporate Vehicles; Limits on Transactions with Covered Funds with Prime Brokerage Exception; Exception for Sale and Securitization of Loans</td>
</tr>
<tr>
<td>Other Limitations:</td>
<td>No transaction, class of transactions, or activity may be deemed permissible if it would: (1) Involve or result in a material conflict of interest; (2) Result in a material exposure to a high-risk asset or a high-risk trading strategy; or (3) Pose a threat to the safety and soundness of the entity or the financial stability of the U.S.</td>
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</tr>
<tr>
<td>Programmatic Compliance:</td>
<td>Internal Policies and Procedures; Internal Controls; Responsibility and Accountability; Independent Testing; Training; Recordkeeping; CEO Annual Attestation</td>
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<tr>
<td>Reporting Requirements:</td>
<td>7 metrics must be reported depending on the aggregate size of the entity’s world-wide trading assets and liabilities, as well as additional metrics, as appropriate</td>
<td>N/A</td>
</tr>
</tbody>
</table>
Fundamental review of the trading book

- Fundamental Review of the Trading Book (FRTB) represents a profound change in market risk in Trading Book. Basel 2.5 increased regulatory capital significantly in trading but issues remained. Hence FRTB …

- BCBS’s objectives were:
  - To develop an effective trading and banking book boundary condition
  - To achieve a regulatory framework that captures and capitalises all risks in the trading book
  - To improve risk measurement techniques
  - To achieve comparable levels of capital across internal risk models and the Standardised approach (SA)

- BCBS is proposing some far reaching changes including:
  - The new trading book / banking book boundary
  - The use of Expected Shortfall (ES) as an alternative to VaR
  - The integration of market liquidity risk with market risk
  - The application of capital floors and supervisory based model parameter calibrations
  - Making the SA more risk sensitive

The proposals are generally a positive step and on the face of it appear to have met the objectives of the new regime
Fundamental review of the trading book potential issues

Overall, this is a positive step towards a more robust trading environment, however, there are a number of issues to be worked through ….

- Changes in banking and trading book boundaries
  - Banks will likely see higher trading book assets

- Adoption of Expected Shortfall (a new risk metric)
  - Banks will have to employ advanced simulation and sampling techniques to measure the distribution of tail events, including many more simulation scenarios to get a meaningful sample of tail events
  - Expected Shortfall back-testing is more complicated than Value-at-Risk back-testing, as both the size and likelihood of losses have to be factored into Expected Shortfall

- Introduction of liquidity Horizons
  - Incorporating liquidity risk is a positive step however, carefully consider action is needed in relation to the use of capital floors for internal models and supervisory correlation

- Revised Internal Models-Based Approach versus standardised approaches
  - Closer alignment is sensible but will it undermine incentive to invest in risk models?

- Substantial operational impacts on risk methodology framework, risk policies and procedures, processes, controls, IT architecture and resources. Maintaining duel systems (IMA & SA) will be a challenge for IMA banks

- Desk level supervision
  - Model approval process is more granular and discrete, including at a desk level
  - Increased focus on P&L Attribution and enhanced daily backtesting
Risk culture and market conduct

The recent environment of regulatory change has driven the need for organisations to adopt a holistic view of risk management and compliance including conduct risk and risk culture.

Risk Management is much more than formal policies and procedures. It is about building a corporate culture where the right people do the right thing at the right time.

Current context …

- Libor Scandal and associated fines
- Investigations into Foreign Exchange markets
- Generally an increased focus on trader surveillance

Regulators are re-evaluating submissions and compilation processes for financial benchmarks in their jurisdictions, with the over-arching goal of re-establishing trust and confidence in financial markets.

Yet another area where governance will need to improve, eg in areas of:

- ownership and accountability
- conflicts of interest management / independence
- training and awareness
- data aggregation and analysis
- Trader surveillance
- review and submission
Joining the dots

- Overlaps need to be identified and managed
  - Desk level oversight
  - Conduct
  - Data underpins everything
  - Liquidity importance
  - Judgement consistencies

- Unintended consequences need to be thought through and managed
  - IMA v SA?
  - Extra-territorial reach
  - Timelines / jurisdictional differences impacts

- New/heightened risks need to be managed
  - Change agenda / organisational bandwidth capacity constraints
  - Conduct / culture
  - CCP concentration
  - Shadow banking
Conclusion

Making sense of all this …….

What does all of this regulatory and related reform mean for Risk Professionals? To respond to this significant and complex regulatory reform agenda, risk professionals will need to:

 be able to measure, monitor and communicate the impacts of new risk measures (eg expected shortfall). These measures will be reported publicly so the role and importance of the risk professional in this communication process becomes critical;

 get much closer to trading activities, given increased regulatory focus and compliance burden attaching to desk level activities and also heightened awareness of market conduct;

 be cognisant of new and emerging risks eg concentration risks associated with CCP’s;

 approach reforms in a strategic and holistic manner and map-out the reform “journey”;

 industrial strength, scalable risk architectures will be a prerequisite in this environment;

 risk management and compliance needs to be more real-time and perhaps more ‘intrusive’.

Implications for 1st Line and 2nd Line.

Time to Step Up ? …….
Creating a culture of risk awareness

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