Global Regulatory Reform
An overview

Colin Fiddes, May 2013
The need for change
“We need a new deal between financial regulation and society. A deal in which financial services are back at the service of the real economy. And at the service of citizens. Citizens who are also taxpayers. Those same taxpayers who are paying the bill of bailing out the banks. Citizens and taxpayers who have lost all trust in the financial system… who won’t forgive us if we don’t learn all the lessons of the crisis. And change what needs to be changed in the financial sector.”

Michel Barnier, 26.4.2010
(EU Commissioner for internal market and services)
What is regulatory reform and what are the objectives?
Policy objectives

**Make the financial system and infrastructure more robust**

- New global, regional and national regulatory architectures – increased focus on macro-prudential regulation and alignment to firm supervision
- Widening the scope of regulation – Bank Holding Companies, hedge funds
- Strengthening market infrastructures – OTC derivatives, securitisation, credit ratings agencies, audit

**Make institutions more resilient and responsible**

- New, stronger requirements for capital and liquidity
- Strengthen governance and risk management
- Focus on risk-aligned remuneration
- Consumer protection initiatives
- Tough, much more intensive supervision / intervention
The evolving global regulatory policy landscape

Improve the system’s ability to manage failure, at acceptable cost

• “Too big to fail”
• What should be allowed within a bank structure?
• Recovery and resolution plans, deposit guarantee schemes
• Contingent capital and “bail-in”
Global regulatory reform

The landscape of future regulatory reform is truly global, extensive and intrusive

- **Dodd-Frank**
  - OTC derivatives
  - Proprietary trading
  - Living wills for ‘too big to fail’
  - Basel III requirements
  - Hedge funds
  - Compensation
  - Securitisation
  - Consumer/investor protection

- **FATCA**
  - Disclosure of US persons and assets to IRS or 30% withholding tax

- **Current US requirements**
  - Sarbanes Oxley
  - SEC Acts
  - CFTC

- **Basel II and III**
  - Core Tier 1 and Tier 2 requirements
  - Capital and capital surcharges
  - Liquidity and liquidity coverage ratio
  - Conservation and countercyclical buffers
  - Leverage ratio
  - NSFR
  - Stress testing

- **Global Regulatory Reform**
  - The G20 summit commitments have led to a host of new regulatory requirements for banks worldwide to add to existing regulatory demand
  - The impact will be particularly heavy on investment banks

- **IFRS Convergence**
  - FASB/IASB convergence
  - IFRS 9 impairment
  - IFRS 9 hedging
  - Asset and liability offsetting
  - Single control model

- **Financial Stability Board**
  - Living Wills (RRPs)
  - Bail In within resolution
  - Cross-border agreement
  - Removing obstacles

- **EU Regulation**
  - AIFMD
  - EMIR
  - Living wills (RRPs)
  - MiFID I and II
  - MLD III and IV
  - UCITS III and IV
  - Solvency II

- **Asia-Pacific Regulation**
  - Investor Protection
  - Legal entity management
  - OTC Derivatives reform

- **EU Tax**
  - Bank Levy (UK, France, Germany)
The proposed measures will impact many aspects of financial firm’s business models.

**Impact considerations**
- Short-term impact
- Longer-term, strategic impact
  - Addressing uncertainty — dependencies, in-flight initiatives and decision points

**Business model**
- Strategic direction
- Top-line revenue
- Margin
- Competition
- Tax optimisation
- Talent retention

**Balance sheet, funding and structure**
- Capital demand
- Capital and funding structure
- Liquidity
- Divestitures
- Legal entity structure
- Tax treatment
- Ratings impacts

**Operations, data and IT**
- Data quality, aggregation and governance
- MIS and reporting
- Strategic investment needs
- Tax models

**Governance, risk and control**
- Board-level engagement
- Risk management organisation
- Resourcing and skill sets
- Ongoing compliance
Who is driving regulatory reform?
Who is driving regulatory reform?

“We are determined to fulfil the commitment we made ...to ensure that all financial markets, products and participants are regulated ... in an internationally consistent and non-discriminatory way.”

Cannes G20 leaders’ declaration 4.11.2011

Policy formation at all levels:

• Major political impetus from G20

• Basel Committee on Banking Supervision, Financial Stability Board, International Organization of Securities Commissions (IOSCO), IAS (International Association of Insurance Supervisors), Senior Supervisors Group

• European Commission, European Parliament, European Central Bank (ECB), Committee of European Banking Supervisors (CEBS), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and Committee of European Securities Regulators (CESR)

• National government, central bank, regulatory and supervisory policy and approach changes – not always consistent, e.g. Bank of England, US SEC, national treasuries, national supervisors
Current state of regulatory reform
Current state of regulatory reform

• Regulators across the globe are moving forward to implement G20 financial reforms
• Main pillars of the reforms appear settled
• Many details regarding national implementation of regulations still to be finalised, e.g. Basel III
• National variation in implementation poses challenges to organisations as they reevaluate implications of reforms for their business models
• Enough is known about the new regulatory landscape for organisations to think strategically about the aggregate impact and to consider effects of regulatory changes in broader context of efforts to reshape and strengthen the business
EU Agenda: Heavy ongoing legislation in financial services

Cultural shift in regulatory reform:

- Regulating **capital markets** and **market actors**
- ‘Safety first’ approach
- Filling in the gaps between European and national regulation
- Fast track model: **Less directives – more regulations**
- More elevated and Pan-EU centralised supervision
- Assertive powers vested with the EU Parliament

- CRD IV
- EMIR
- CCPs, trade repositories
- Bank Resolution & Recovery
- OTC Regulation
- Solvency II
- Packaged Retail Investment Products
- UCITs V
- Shadow Banking
- MiFID II
- Market Abuse Directive II
- EU Mortgage Credit Directive
- Corporate Governance Framework
- Insurance Mediation Directive
Regardless of costs, regulatory reform is here to stay

All that is of systemic importance should be regulated and supervised.

To restore trust, investors and consumers should encounter clearer, more coherent and more effective safeguards.

Supervisory bodies should have the right tools to grasp the complex, interconnected and globalised financial nature of activities.

There is a need for a better capitalised finance industry with less leverage.

Perverse incentives in the financial sector should be tackled and reduced.
Regulatory structures
Regulatory architecture changes – the UK and European regulatory structure

**European Systemic Risk Board**
- Special Resolution Unit – resolution of banks
- Regulation of systemic infrastructure – CCPs, settlement, payment systems

**European Banking Authority, European Insurance & Occupational Pensions Authority**
- Financial Policy Committee
  - Macro-prudential regulation
  - Monitoring stability and resilience
  - Tools to address risk including recommendations and directions
- Prudential Regulation Authority
  - Promotion of stability of UK financial system
  - Operational objective to regulate the safety and soundness of firms, so as to improve financial stability
  - Insurance – securing an appropriate degree of protection for policyholders
  - Implement FPC’s macro-prudential policy
  - Prudential rule-making
  - Recovery/resolution plans
  - Authorisation, permissions, supervision, enforcement

**European Securities & Markets Authority**

**Bank of England**
- Financial Conduct Authority
  - Ensuring that relevant markets function well
  - Operational objectives to: promote effective competition in the interests of consumers, secure an appropriate degree of protection for consumers; and protect and enhance the integrity of the UK financial system
  - Proposed transfer of consumer credit regulation from the OFT (model to be determined)
  - Oversight of FOS, FSCS and CFEB
  - Conduct of business rule-making; authorisation, permissions, supervision, enforcement
  - Product intervention powers
  - Market abuse powers

**Who regulates what?**

<table>
<thead>
<tr>
<th>Banks, building societies, insurers, certain systemic investment firms</th>
<th>Other investment firms, brokers, advisers</th>
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<tr>
<td>PRU</td>
<td>PRA</td>
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"The PRA will take a forward-looking and judgment-based approach to supervision … early interventions (where necessary) driven by a new Proactive Intervention Framework (PIF)."

(Andrew Bailey, 19.5.2011)

"I want the culture in your firms, from your product governance to your sales, to be aligned with the best interests of customers … The FCA will need to ask tougher questions … and then needs to make better, bolder, faster decisions."

(Martin Wheatley, January 2012)
Structure

- Moving to a “twin peaks” model:
  - SARB (financial stability and prudential supervision)
  - Financial Services Board (market conduct supervision)

Adoption of international regulations

- SA is member of G20 and Financial Stability Board
- Adopting global leading practice, in line with regulatory reform policy objectives, including Basel III
- Implementing international financial standards promoted by Financial Stability Board

Current SA regulatory structure

<table>
<thead>
<tr>
<th>SARB</th>
<th>Minister of Finance</th>
<th>Minister of Health</th>
<th>Minister of Trade &amp; Industry</th>
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<tbody>
<tr>
<td>• National Payments System Department</td>
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<td>• Financial Intelligence Centre (FIC)</td>
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<td>• Development Agency for Co-operative Banks</td>
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<td>• Bank Supervision Dept/Registrar of Banks &amp; Supervisor of Co-operative Banks</td>
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<td>• Land Bank</td>
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<tr>
<td>• Council for Medical Aid Schemes/Registrar of Medical Aid Scheme</td>
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<tr>
<td>• Competition Commissioner</td>
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<td>• National Credit Regulator (NCR)</td>
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<td>• National Consumer Commission</td>
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Future SA regulatory model

Financial Stability Oversight Committee

<table>
<thead>
<tr>
<th>Systemic Regulator</th>
<th>Prudential Supervision</th>
<th>Market Conduct Supervision</th>
<th>Other</th>
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<tbody>
<tr>
<td>SARB</td>
<td>Ex-SARB BSD</td>
<td>Ex-FSB</td>
<td>NCR and Others</td>
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<tr>
<td>• Industry</td>
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<td>• Banks</td>
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<td>• Ex-FSB</td>
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<tr>
<td>• Financial Advisory</td>
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<td>• Pension Funds</td>
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<td>• Rating agencies</td>
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Cooperation and information sharing
Key developments
Key developments

Prudential regulations

• Basel II and III
• Solvency II / Solvency Assessment and Management (SAM)
• Recovery and Resolution planning
• Dodd-Frank Act
• Risk governance

Market conduct regulations

• Consumer Protection – Treating Customers Fairly
• FATCA
• Anti-Money Laundering

Other

• Internal Audit effectiveness
• Integrated reporting
Basel II

What is this about?

• Effective 2008
• Introduces risk-based capital requirement
• 3 pillars – minimum regulatory capital, internal capital, disclosure
  - Minimum regulatory capital covers credit, market and operational risk
    • Allows 3 methods – regulator-prescribed through to internal models
    • Sets out qualitative risk management requirements
• Internal capital – captures all other risks
• Disclosure – designed to explain risk management practices and exposures

Obligation / impact on firms

• Comply with the accord as adopted by national regulator
• Meet demonstrable use test

Opportunities

• Review risk management practices in line with international frameworks
• Assess capital adequacy requirements
• Enhance risk management disclosure
• Support confidence and trust
Basel III

What is this about?

• Enhancement of standards of capital quantity and quality, liquidity and stress testing for banks

Obligation / impact on firms

• Increase the quantity and quality of capital that banks hold
• Hold capital buffers which would be built up during good years to support firms during poorer years
• Introduce a defined leverage ratio on capital
• Introduce a minimum liquidity requirement which would enable banks to meet their liquidity requirements for 30 days.
• Increase the robustness of stress testing, risk management and governance.
• Systemically important banks would have additional requirements on capital, buffers and liquidity.

Opportunities

• Better able to manage liquidity risk
• Clearer funding profile
Solvency II / SAM

What is this about?

- Fundamental review of the capital adequacy regime for the European insurance industry
- 3 pillars – capital requirements, risk management and governance, disclosure
- SAM is a Solvency II equivalent, risk-based supervisory regime for prudential regulation of insurers in South Africa.

Obligation / impact on firms

- Assess adequacy of financial resources – firm needs to be adequately capitalized with risk-based capital
- Conduct own risk and solvency assessment (ORSA)
- Assess formalised risk management and governance processes against Solvency II standards. Core functions and processes required to support risk management system - risk management, compliance, actuarial, internal audit
- Assess reporting processes for ability to comply with new reporting requirements to supervisors and public disclosures
- SAM will affect South African insurers in a similar way as Solvency II for European insurers, will have an impact on the whole value chain of insurance firms and will have same implementation date.

Opportunities

- Develop greater awareness of the risk to which the business is exposed and place more emphasis on the strategic management of the risk portfolio and capitalisation
- Improve risk management processes, practices, governance and disclosure
- Review and improve data and data quality practices
Recovery and Resolution planning

What is this about?

• Post GFC, G20 moved to minimise “bail-outs”
• RRPs aim to ensure that financial institutions:
  • Assess and document the recovery options available to them in a range of severe stress situations
  • Enable these recovery options to be mobilised quickly and effectively, and
  • Enable regulatory authorities with the information and analysis of their businesses, organisation and structures to enable the authorities to ensure an orderly resolution can be carried out
• Financial Stability Board (FSB) developed a framework that applies to global systemically important banks (G-SIBs)
• BIS produced guidance for domestic systemically important banks (D-SIBs)

Obligation / impact on firms

• Banks and other systemically important financial institutions (SIFIs) have to develop detailed plans for how they will recover from financial stress situations, incl. triggers and responses
• Develop resolution packs that will allow authorities to intervene in event that the recovery plan failed, to resolve the institution with the minimum of systemic disruption, customer detriment and public cost
• National regulators need to identify D-SIBs and apply the G-SIB framework, effective January 2016

Opportunities

• Assess and rationalise organisational structure
• Identify capital -heavy operations
• Identify and develop stress scenarios
“Too big to fail” firms: renewed focus on recovery capability, and on failure without taxpayer loss

Development of recovery plans are an extension of firms’ approach to Pillar 2 and stress testing, and firms should be able to articulate a consistent view between capital targets, stress tolerances and potential crisis/failure thresholds. Bail-in would support either Recovery or part fund Resolution activities.
Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act)

**What is this about?**

- Promotion of financial stability of the United States:
  - By improving accountability and transparency in the financial system
  - To end "too big to fail"
  - To enhance market transparency and integrity – market conduct standards
  - To protect consumers from abusive financial services practices
- Aims to prevent another financial crisis by creating new financial regulatory processes that enforce transparency and accountability and protect consumers

**Obligation / impact on firms**

- Assess business operations for Dodd Frank implications
  - Derivatives Trading / Global Markets businesses may be impacted - dealing in Swaps with US based counterparties and special entities
  - Monitor de-minimis thresholds (notional value of trades in rolling 12 month period)
    - $8 billion of trades with US based counterparties, or
    - $25 million of trades with Special Entities
  - Register with the CFTC as Swap Dealer / Major Swap Participant
  - Clearing arrangements - all swaps cleared through a clearing house
  - Internal and External business conduct requirements
  - Reporting and record-keeping requirements

**Opportunities**

- ???
Risk governance

What is this about?
- GFC attributed largely to governance failures
- G20, BIS, FSB, G30 and others developed risk governance guidance
- Key issues – risk oversight, risk appetite, risk culture, risk model dependence, risk reporting, compensation, poor risk decisions

Obligation / impact on firms
- Critically evaluate risk structures and practices
  - Risk strategy
  - Risk appetite
  - Risk culture
  - Risk structure – risk committees, CRO standing, risk function positioning
  - Risk policies and practices
  - Risk reporting and escalation
  - Risk skills and competence
  - Engagement with regulators
  - Compensation and reward practices
  - Alignment of risk and control functions

Opportunities
- Position risk and control functions as core competence
- Align risk management activities with strategy and business objectives
- Optimise lines of defence activities
Consumer protection – focus on Treating Customers Fairly (TCF)

What is this about?

• Ensuring fair treatment of customers is embedded within the culture of FIs
• The TCF outcomes
  • Customers confident that TCF is central to the FI’s culture
  • Products and services are designed to meet needs of identified consumer groups and targeted accordingly
  • Consumers provided with clear information and kept informed before, during and after the point of sale
  • Where consumers receive advice, advice is suitable and takes account their circumstances
  • Consumers provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect
  • Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

Obligation / impact on firms

• Embed a TCF culture, supported by controls, governance structures, management information and self-assessment
• Demonstrate that TCF outcomes have been achieved
• Meet TCF reporting and disclosure requirements

Opportunities

• Enhancing customer strategy
• Improve customer service and experience
• Build customer-centric brand
Foreign Account Tax Compliance Act (FATCA)

What is this about?

- Preventing US taxpayers from avoiding US tax by investing through non-US financial institutions and offshore investment vehicles
- Imposing new information reporting and compliance requirements on FIs
- Foreign Financial Institutions (FFIs) to enter into agreements with US IRS to become participating FFIs (PFFIs) on or before 1 January 2014 if applicable
- Imposing a 30% withholding tax on certain US source payments made to:
  - Institutions that choose not to participate in FATCA
  - Investors that refuse to be documented

Obligation / impact on firms

- Assess business operations for FATCA implications
- Decide whether to become FATCA compliant and enter into an agreement with the US IRS (advisable to start the process in mid-2013 to avoid being non-compliant)
- Conduct a classification exercise of existing US customers (individuals and entities) and counterparties
- Change customer on-boarding processes, systems and data to be FATCA compliant
- Implement FATCA-specific regulatory reporting requirements - reduced complexity and burden in Inter-Governmental Agreement (IGA) jurisdictions
- Withhold 30% of US-source income on non-compliant customers and counterparties

Opportunities

- Prevent competitive disadvantage from application of 30% withholding tax
- Ease of doing business with other compliant FIs
Anti-Money Laundering

What is this about?

• Anti-money control failures led to some of largest recent penalties and fines
• Proceeds of crime and terrorist financing activities are receiving greater attention
• Greater obligations on financial institutions to monitor, identify and report suspicious activities
• FATF approved jurisdictions are enhancing their anti-money laundering risk and control environments in line with the FATF framework for sound practice

Obligation / impact on firms

• Assess anti-money laundering process compliance with with FATF framework
  • Example: UK FSA: “A firm must take reasonable care to establish and maintain effective systems and controls for compliance …. And for countering the risk that the firm might be used to further financial crime.” (SYSC 3.2.6)
• In the UK the FSA supplements this rule with provisions requiring a firm:
  • To enable it to identify, assess, monitor and manage its money laundering risk
  • To ensure that its systems and controls are comprehensive and proportionate to the nature, scale and complexity of the firm’s activities
  • To make a director or senior manager responsible for meeting its objectives on money laundering systems and controls and for reporting to its governing body on this
  • To carry out regular assessments of the adequacy of its systems and controls
  • To appoint a Money Laundering Reporting Officer (MLRO) to act as a focal point for oversight of the firm’s AML activities with an adequate level of authority, access and resources

Opportunities

• Engage with credible clients and counterparties
• Conduct business with integrity
• Instil confidence in stakeholders
• Build a sustainable business

Financial Services Strategic Forum
Internal Audit effectiveness

What is this about?

- US Federal reserve and UK FSA through the UK CIIA developed guidance to enhance focus and conduct of internal audit functions
- Areas covered by the proposed guidance includes the Role and mandate of IA; Reporting; Interaction with other control functions; Independence; Quality and Engagement with regulators.
- The Scope includes:
  - Design and effectiveness of organisation governance
  - Strategic and management information
  - Setting of, adherence to risk appetite
  - Risk and control culture
  - Risks of poor customer outcomes (TCF)
  - Capital and Liquidity risk (and regulatory)
  - Key corporate events
  - Outcomes of processes

Obligation / impact on firms

- Once adopted, the code will set the standard against which FS firms’ internal audit functions are assessed

Opportunities

- Assess current internal audit structure, function and capability against proposed code of conduct to identify areas for improvement
Integrated reporting

What is this about?

• The IIRC published the consultation draft for integrated reporting
• An integrated report is a concise communication about how an organization’s strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term
• A pilot study has been concluded, including preparers and institutional investors
• Demand from providers of capital for concise value-relevant information is driving the initiative

Obligation / impact on firms

• New corporate reporting model
• Consider:
  • Evaluate requirements
  • Assess benefits to stakeholders
  • Participate in industry engagement
  • Engage key stakeholders on needs and expectations / understanding
  • Comment on consultation document

Opportunities

• Adapt existing corporate reporting and disclosures
• Enhance understanding of stakeholders expectations
Other regulatory developments

• Legal Entity Indicator
• Shadow banking
• Rating agencies
• Access to finance
• ESMA
• Privacy
Challenges for FS institutions

- Reforming business models in uncertain environment
- Cutting costs while implementing higher regulatory requirements – what is the business opportunity?
- Capital and funding pressures remain high
- Pressures for industry consolidation
- Added pressure for deposit-taking global systemically important financial institutions
- Engage the regulator; influence and understand; fit for purpose national adoption
- Greater regulator and counterparty scrutiny
- Stakeholder demands
- Demand for skills and experience
- Board and senior management responsibilities

Substance over form, proportional application
Key considerations for the c-suite

- Are you aware of the latest international regulatory reforms?
- Have you considered the opportunity and business benefit of adopting the reforms on your business model, governance framework, operations and funding structure?
- Have you considered the actions that you could take, based on your understanding of the challenges and practical considerations?
- Actions, to respond effectively, could include:
  - Develop and maintain capability to manage regulatory change across the enterprise
  - Articulate business models and strategy clearly
  - Strengthen risk governance frameworks
  - Enhance and integrate data and reporting
  - Implement corporate-level compliance risk management
  - Drive integrated, efficient and forward-looking capital and liquidity planning
  - Create sustainable RRPs and integrate them into ongoing risk governance processes
  - Enhance operational efficiency
Ernst & Young

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