S7C

A GLOBAL REGULATORY SNAPSHOT

SESSION 2

TRAINING COURSE
A GLOBAL REGULATORY SNAPSHOT
2018

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G20 COUNTRIES

- Argentina.
- Australia.
- Brazil.
- Canada.
- China.
- The European Union.
- France.
- Germany.
- India.
- Indonesia.
- Italy.
- Japan.
- Mexico.
- Russia.
- Saudi Arabia.
- South Africa.
- South Korea.
- Turkey.
- United Kingdom.
- United States.

Global Regulatory Compliance Frameworks

- Alternative Investment Fund Managers Directive (AIFMD).
- Bank Recovery and Resolution Directive (BRRD).
- Basel III.
- Basel IV.
- Canada Derivatives Trade Reporting.

Global Regulatory Compliance Frameworks *(cont)*

- Capital Requirements Regulation (CRR).
- Central Securities Depository Regulation (CSDR).
- Dodd-Frank Act.
- Dodd-Frank Volcker Rule.
- European Market Infrastructure Regulation (EMIR).

Global Regulatory Compliance Frameworks *(cont)*

- Foreign Account Tax Compliance Act (FATCA).
- Fundamental Review of the Trading Book (FRTB).
- Market Abuse Regulation (MAR).
- Markets in Financial Instruments Regulation (MiFIR).
- Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation.

Global Regulatory Compliance Frameworks *(cont)*

- Recovery and Resolution of Central Counterparties Regulation.
- Revised Capital Requirements Directive (CRD IV).
- Revised Market Abuse Directive (MAD 2).
- Revised Markets in Financial Instruments Directive (MiFID II).

Global Regulatory Compliance Frameworks *(cont)*

- Revised Payment Services Directive (PSD 2).
- Securities Financing Transaction Regulation (SFTR).
- Target2-Securities (T2S).
- Updated Undertakings for Collective Investments in Transferable Securities (UCITS V).

Central Securities Depositories Regulation

- The Central Securities Depositories Regulation (CSDR) is one of the key regulations adopted in the aftermath of the financial crisis. CSDR is part of the wider European Union (EU) regulatory reforms, including the European Market Infrastructure Regulation (EMIR) and revised Markets in Financial Instruments Directive II (MiFID II), which between them, cover the entire securities and capital markets structure, with a view to improving the functioning and stability of the financial markets.

Central Securities Depositories Regulation *(cont)*

- CSDR introduces new measures for the authorisation and supervision of EU Central Security Depositories (CSDs), and sets out to create a common set of prudential, organisational, and conduct of business standards at a European level.
- A large part of CSDR is designed to support the achievement of the objectives of the Target2Securities (T2S) system, by the introduction of a securities settlement discipline regime.

Central Securities Depositories Regulation *(cont)*

- This harmonises operational aspects of securities settlement, including the provision of shorter settlement periods, mandatory buy-ins, and cash penalties, to prevent and address settlement fails.
- The new rules also stipulate that CSDs will need to apply for authorisation from their national competent authorities.

Scope

- The CSDR applies to all European CSDs and to all market operators in the context of securities settlement.
- Trading parties, central counterparties (CCPs), clearing and settlement agents (which are members of the CCPs and CSDs) and trading venues will also be impacted and will have to directly comply with some of the measures, in particular the introduction of the mandatory buy-in regime and cash penalties for settlement failures.

Scope *(cont)*

- It should be noted that members of the European System of Central Banks and other national or public bodies that perform similar services, which would otherwise qualify as CSDs are exempt from certain requirements under the CSDR, including those relating to authorisation.

Key Objectives

- To harmonise the different rules applicable to the CSDs in Europe;
- To establish a level playing field among these CSDs;
- To increase the safety of securities settlement and the settlement infrastructures in the EU;

Key Impacts

- Article 3 – Book-entry form: Any issuer established in the EU that issues or has issued transferable securities which are admitted to trading or traded on trading venues, is required to arrange for such securities to be represented in book-entry form;
- Article 5 – T+2 settlement cycle which brings all CSDs onto a harmonised model for completing settlement for on-exchange trades two days following the transaction date;

Key Impacts *(cont)*

- Articles 6 and 7 set out a new settlement discipline regime.
- CSDs are obliged to implement a penalty mechanism for settlement fails which will serve as a deterrent for participants (such as Pershing) and their clients that cause settlement fails along with a mandatory buy-in process on any financial instrument which has not been delivered within a set period of the intended settlement date.

Key Impacts *(cont)*

- The European Securities and Markets Authority (ESMA) has drafted technical standards on settlement discipline to establish the parameters for the calculation of cash penalties for settlement fails;

Key Impacts *(cont)*

- Article 9 provides for internalised settlement reporting, whereby a settlement "internaliser" must report, to the competent authorities of their place of establishment, on a quarterly basis, the aggregated volume and value of all securities transactions that they settle outside securities settlement system.
- ESMA has drafted technical standards to establish the forms, templates and procedures for the reporting and the transmission to the relevant competent authorities. This would apply, for example where two Pershing client firms trade (on behalf of their underlying clients) between themselves;

Key Impacts *(cont)*

- Article 38 places an obligation on CSDs and their direct participants to offer their clients the choice between omnibus segregation and individual client segregation and to inform them of the costs and risks associated with each option;
- Article 38 also requires CSDs and their participants to publicly disclose the levels of protection and the costs associated with the different levels of segregation.

CSDR Implementation Timeline

- **The regulation entered into force across all member states on 17 September 2014, although a number of provisions apply at a later date. Key dates include:**

Time	Term
March 2017	Regulatory Technical Standards (**RTS**) and Implementing Technical Standards (**ITS**) on CSD Requirements published in the official journal and entered into force 20 days later (except for settlement discipline related obligations).
September 2017	CSDs must have applied for and submitted applications for authorisation to their national competent authorities.
March 2018	Final guidelines on how to report internalised settlement published by ESMA.

CSDR Implementation Timeline (cont)

Time	Term
May 2018	RTS concerning CSDR Settlement Disciplines published.
Q4:18/Q1:19	CSDs and their participants must comply with the new CSDR requirements detailed in the RTS upon receipt of their authorisation approval from their national competent authority.
10 March 2019	RTS on Internalised Settlement apply.
12 July 2019	First Internalised Settlement report due to the national competent authority.
Q3:20	Entry into force of the settlement discipline rules (two years after publication in the Official Journal).
1 January 2023	Certified securities to be transferred into book-entry form for transferable securities issued after that date (1 January 2025 for all transferable securities).

Alternative Investment Fund Managers Directive

- The Alternative Investment Fund Managers Directive (AIFMD) (2011/61/EC) went into effect on 21st July 2011.
- Alternative Investment Fund Managers (AIFMs) (i.e. hedge funds, private equity funds, real estate funds, and institutional funds) have faced a number of significant operational implementation challenges.

Alternative Investment Fund Managers Directive *(cont)*

- The AIFMD seeks to implement harmonised conditions on the structure and operation of AIFMs. Under the AFIMD AIFMs also benefit from a passport to market Alternative Investment Funds (AIFs) to professional investors across the EU.
- AIFMs can also manage AIFs domiciled in Member States other than the AFIM's home Member State.
- All AIFMs covered by the AIFMD must be authorised to manage or market relevant AIFs.

Alternative Investment Fund Managers Directive *(cont)*

- The AIFMD provided for a broad range of secondary measures to be enacted in order to provide more operational details, and these took the form of a regulation (Level 2 Regulation) which was directly applicable across all EU Member States.

Alternative Investment Fund Managers Directive *(cont)*

- The AIFMD applies to:

(1) EU AIFMs which manage one or more AIFs (regardless of whether the AIFs are EU or non-EU AIF;

(2) non-EU AIFMs who manage EU AIFs;

(3) non-EU AIFMs who market their AIFs in the EU.

AIFMD Risk Management

- Under the AIFMD, AIFMs are required to functionally and hierarchically separate the risk management function from operational units (including any Portfolio Management Function (PMF)), in order to ensure independent performance of risk management activities.
- AIFMs must put in place specific safeguards against conflicts of interest , and ensure adequate risk management systems to appropriately identify, measure, manage, and monitor all risks to which each Alternative Investment Fund (AIF) is exposed (including investment strategy).

AIFMD Risk Management *(cont)*

- The new AIFMD risk management system must establish, implement, and maintain:

(1) a permanent risk management function (RMF);

(2) an adequate and documented Risk Management Policy (RMP); and

(3) quantitative or qualitative risk limits (or both) for each managed AIF (taking into account all relevant risks, AIF strategies and assets employed, and national AIF rules).

AIFMD Risk Management *(cont)*

- AIFMs must also adopt adequate and effective arrangements, processes, and techniques to identify, measure, manage, and monitor risks to which managed AIFs are or might be exposed, including periodic back-testing, periodic stress testing, and scenario analyses relating to adverse market risks.

AIFMD Risk Management *(cont)*

- These risk management systems must be assessed, monitored, and periodically (at least once a year) reviewed, in order to review the degree of AIFM RMP compliance, and to ensure the adequacy and effectiveness of:

(1) the RMP;

(2) the performance of the RMF;

(3) measures taken to address risk management deficiencies; and

(4) measures aiming to ensure functional and hierarchical separation.

AIFMD Liquidity Management

- In order to address liquidity concerns, AIFMs must employ an appropriate Liquidity Management System (LMS) for each managed AIF, and must also adopt procedures that allow AIFMs to monitor AIF liquidity risk, and to ensure that the liquidity profile of an AIF's investments complies with the AIF's underlying obligations.
- AIFMs are also required to ensure that the investment strategy, liquidity profile, and redemption policy of each managed AIF are consistent , and must conduct regular stress testing (under normal and exceptional liquidity conditions) in order to assess and monitor AIF liquidity risk.

AIFMD Liquidity Management *(cont)*

- The LMS should at a minimum ensure that the AIFM:

(1) maintains AIF liquidity at a level appropriate to underlying obligations;

(2) monitors the liquidity profile of the AIF's portfolio of assets;

AIFMD Liquidity Management *(cont)*

(3) implements and maintains appropriate liquidity measurements arrangements and procedures to assess quantitative and qualitative risks of positions, in order to enable their effects on the overall liquidity profile to be appropriately measured; and

(4) considers and puts into effect tools and arrangements (including special arrangements) necessary to manage the liquidity risk of each managed AIF under normal and exceptional circumstances.

AIFMD Liquidity Management *(cont)*

- Whilst this provides a high level overview of the new AIFMD risk management and liquidity management operational requirements, there are more detailed requirements stipulated in the AIFMD Delegated Regulation (No 231/2013).
- AIFMDs will likely find it highly challenging to implement proportional and cost-effective risk and liquidity management systems that can effectively address the new and stringent AIFMD requirements.

Appointment of a Third-Party Depositary

- Under the AIFMD all AIFMs must appoint a single depository for each AIF it manages.
- In practice, the appointment of a suitably qualified and resourced depositary may be a time consuming and difficult process to follow.
- For AIFs based in the EU, depositaries must be based in the home Member State of the AIF, thereby limiting the choice of depositary.

Appointment of a Third-Party Depositary *(cont)*

- The appointment of a depositary must also be evidenced by a written contract that adheres to 18 detailed contractual particulars that must be contained within the contract, e.g. services to be provided for each asset type, description of safe-keeping and oversight functions to be performed for each asset type and geographical region, confidentiality obligations.

Appointment of a Third-Party Depositary *(cont)*

- Depositaries also face what has been anecdotally referred to as 'near strict liability' in respect of the safekeeping of assets (including AIF collateral assets), which means AIFMs must ensure that a depositary is both sufficiently capitalised in order to meet such level of liability and has sufficiently reviewed risks within any existing sub-custodian network.

Appointment of a Third-Party Depositary *(cont)*

- A depositary is also obliged to assess the risks associated with the nature, scale and complexity of the AIF's strategy and the AIFM's organisation in order to devise appropriate AIF oversight procedures.
- Rising AIFMD compliance costs, together with limitations on the use of AIF collateral, may result in some AIFMs opting for undercapitalised depositaries with latent sub-custodian risks, and increased AIFMD operational risk.

AIFMD Data Management and AIFMD Annex IV Reporting Obligations

- **AIFMs may find it particularly challenging to adapt existing data management systems to comply with new AIFMD reporting obligations.**
- **AIFMD disclosures include initial and ongoing investor disclosures (e.g. AIF objectives, strategy, leverage, depositary, vehicle, historical performance, net asset value) and regulatory reporting.**

AIFMD Data Management and AIFMD Annex IV Reporting Obligations *(cont)*

- AIFMs need to collect data from a range of disparate sources (e.g. asset managers, custodians, and administrators), and countries (e.g. multi-jurisdiction operating model), and so may have difficulty designing and implementing a cost-effective AIFMD reporting architecture.
- AIFMs must provide an Annex IV AIFM report which provides management and fund information, and an Annex IV AIF report for each fund held containing information relating to assets, risks, and investor types.

AIFMD Data Management and AIFMD Annex IV Reporting Obligations *(cont)*

- These reports must be submitted on an annual, semi-annual, or quarterly basis (dependant on the type of AIF), and different EU Member States may have different reporting timelines.
- AIFMs must answer 41 detailed questions; choose from nine variations of the AIFM report or 45 variations of the AIF report; populate 38 data fields for the AIFM, or 302 data fields for each AIF; complete each report within a 30 day timeframe.

AIFMD Data Management and AIFMD Annex IV Reporting Obligations *(cont)*

- The increased level of granularity of data required for AIFs , strategies , investments , financial instruments ; structures , and risk profile , may make mapping of Annex IV data to existing data subsets (e.g. investors, market risk, liquidity risk, counterparty risk, and trading data) particularly onerous.
- AIFMs must also ensure that they have systems in place to extract data from the relevant systems or repositories, aggregate the data, validate the data, and perform controls testing and audit procedures.

AIFMD Data Management and AIFMD Annex IV Reporting Obligations *(cont)*

- **The increased level of granularity of data required for AIFs , strategies , investments , financial instruments ; structures , and risk profile , may make mapping of Annex IV data to existing data subsets (e.g. investors, market risk, liquidity risk, counterparty risk, and trading data) particularly onerous.**

AIFMD Data Management and AIFMD Annex IV Reporting Obligations *(cont)*

- **AIFMs must also ensure that they have systems in place to extract data from the relevant systems or repositories, aggregate the data, validate the data, and perform controls testing and audit procedures.**
- **An efficient and reliable outsourced Annex IV reporting solution may therefore be the most cost-effective method of AIFMD compliance for many AIFMs.**

BASEL III AND CRD IV

- New prudential rules for banks, building societies and investment institutions are set out in a new European Union (EU) legislative package governed by the Capital Requirements Directive (2013/36/EU) (CRD) and the Capital Requirements Regulation (575/2013) (CRR) (together CRD IV).
- This new capital requirements framework replaces the previous Banking Consolidation Directive (2006/48/EU) and Capital Adequacy Directive (2006/49/EU) that existed in the EU.

BASEL III AND CRD IV *(cont)*

- According to the United Kingdom (UK) Financial Conduct Authority (FCA):
- The aim of CRD is to ensure institutions are able to meet their liabilities as they fall due and to minimise the negative effects of institutions failing by ensuring that institutions hold enough financial resources to cover the risks associated with their business (FCA, 2016).

The CRD IV Framework

CRD	CRR
EU Member States to transpose and implement through national law	***Directly applicable throughout the EU with detailed prescriptive rules***
Access to the taking up and pursuit of business.	Counterparty credit risk.
Capital buffers.	Capital (capital requirements).
Corporate governance.	Capital (own funds).
Exercise of freedom of establishment.	Large exposures.
Passporting and free movement of services.	Disclosure requirements.
Prudential supervision.	Liquidity (liquidity coverage).
Remuneration.	Liquidity (stable funding).
Sanctions.	Leverage.
Third country relations.	Institutional disclosures.

The CRD IV Framework *(cont)*

- CRD IV aims to improve regulatory capital requirements by tightening Tier 1 and Tier 2 capital requirements and abolishing the use of the Tier 3 capital standard.
- Tier 1 (going concern) capital allows firms to continue their activities and helps to prevent insolvency, with the purest form being Common Equity Tier 1 (CET1) capital.

The CRD IV Framework *(cont)*

- Tier 2 (gone concern) capital helps to ensure that depositors and senior creditors can be repaid if a institution fails.
- Tier 1 capital requirements require a firm to hold a minimum of 6% of risk-weighted assets (RWAs), a minimum CET of 4.5%, and a minimum capital ratio of 8%.

The CRD IV Framework *(cont)*

- The CRD IV framework also introduces:

(1) a new leverage ratio;

(2) a new 'Liquidity Coverage Ratio' (LCR);

(3) a new 'Net Stable Funding Ratio' (NSFR);

(4) new requirements for counterparty credit risk;

(5) new corporate governance requirements;

(6) new remuneration provisions;

The CRD IV Framework *(cont)*

(7) a single set of harmonised prudential rules;

(8) a new capital conservation buffer (CACB);

(9) a new counter-cyclical buffer (COCB);

(10) a new systemic risk buffer (SRB);

(11) a new global systemic institutions buffer (G-SIB); and

(12) a new other systemic institutions buffer (O-SIB).

The CRD IV Framework *(cont)*

- The LCR measures the value of the stock of High Quality Liquid Assets (HQLA) in stressed conditions, relative to total Net Cash Outflows (NCO) calculated according to scenario parameters over a 30 day period.
- Firms are expected to meet the 100% LCR requirement on an ongoing basis and hold a stock of unencumbered HQLA to address the potential onset of a liquidity stress scenario.

The CRD IV Framework *(cont)*

- **The NSFR measures the amount of available stable funding, relative to the amount of required stable funding, with a ratio equal to at least 100% on an on-going basis.**
- **The NSFR seeks to ensure firms maintain a stable funding profile in relation to their on-balance sheet and off-balance sheet activities.**
- **A range of new capital buffers seek to strengthen institutional resilience in periods of negative economic conditions, and a new leverage ratio that will be introduced seeks to prevent banks circumventing secure and long-term capital requirements.**

FINREP and COREP Reporting

- The new CRD IV framework also covers the new Financial Reporting Standard (FINREP) and Common Reporting Standard (COREP) frameworks.
- There are a number of FINREP and COREP reporting challenges that institutions now face and overcome if they are to develop and implement a robust FINREP and COREP reporting and governance process.
- Given the sheer complexity of the CRD IV and FINREP and COREP frameworks, institutions have to make extremely informed decisions about any FINREP and COREP compliance solutions they may adopt.

FINREP and COREP Reporting *(cont)*

- At a minimum regulatory compliance will require a strategic analysis and holistic review across a wide range of operational, organisational, IT and infrastructure, and strategic areas.
- The Financial Reporting Standard (FINREP) governs the consolidated reporting of financial information by CRD credit institutions to their National Competent Authorities (NCAs) on an annual basis.
- Credit institutions are defined as "an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account".

FINREP and COREP Reporting *(cont)*

- The new Common Reporting Standard (COREP) framework governs the reporting of risk (credit, market, operational, solvency, capital) on a monthly and quarterly basis to NCAs.
- These frameworks seek to improve transparency and standardisation in EU regulatory data reporting practices and also to provide NCAs with increased amounts of data to allow them to more effectively undertake supervisory practices.
- COREP reporting took effect from 1st January 2014 and full implementation is required by 1st January 2019.

FINREP and COREP Reporting *(cont)*

- The FINREP framework is based on reporting templates that cover two data segments:

(1) "core" (Primary Statements Consolidated Balance Sheet); and

(2) "non-core" (Primary Statements Consolidated Income Statement) quantitative financial data.

- The submission of non-core data is intended to augment the harmonization and convergence of supervisory reporting across the EU.

FINREP and COREP Reporting *(cont)*

- Other areas included in the FINREP templates include:

(1) Primary Statements (Comprehensive Income and Equity);

(2) disclosure of financial assets and liabilities;

(3) financial asset disclosures and off-balance sheet activities; and

(4) financial asset disclosures and off-balance sheet activities and non-financial instruments disclosures.

- The FINREP framework requires credit institutions to categorise financial instruments following the portfolio approach.

FINREP and COREP Reporting *(cont)*

- **Asset classes include:**

(1) financial assets held for trading;

(2) financial assets designated at fair value via profit and loss;

(3) available-for-sale financial assets;

(4) held-to-maturity investments; and

(5) loans and receivables (includes finance leases).

FINREP and COREP Reporting *(cont)*

- Liabilities are presented as:

(1) financial liabilities held for trading;

(2) financial liabilities carried at amortised cost; and

(3) financial liabilities designated at fair value via profit and loss.

- FINREP reporting is carried out on an annual basis.

FINREP and COREP Reporting *(cont)*

- The COREP framework requires institutions to report on a monthly and quarterly basis detailed information covering:

(1) capital adequacy (own funds, capital ratios, memorandum items);

(2) group solvency;

FINREP and COREP Reporting *(cont)*

(3) credoit and counterparty risk (including securitizations);

(4) operational risk;

(5) market risk;

(6) large exposures;

(7) leverage ratios; and

(8) liquidity ratios.

FINREP and COREP Reporting *(cont)*

- In practice the COREP reporting framework is highly complex as these high level reporting categories are then broken down into sub-categories for which institutions must source and consolidate highly granular data across multiple disparate sources.
- For credit and counterparty risk institutions must population multiple templates relating to areas such as:

(1) credit and counterparty credit risk and free deliveries;

FINREP and COREP Reporting *(cont)*

(2) geographical breakdown of exposures by residence of the obligor;

(3) breakdown of total own funds requirements for credit risk of relevant credit exposures by country;

(4) settlement/delivery risk;

(5) market risk: standardised approach for position risks in traded debt instruments;

(6) market risk: standardised approach for commodities;

(7) exposures in the non-trading book; and

(8) leverage ratio calculation.

TARGET2-SECURITIES

- TARGET2-Securities (T2S) is a European securities settlement engine which offers centralised delivery-versus-payment (DvP) settlement in central bank money across all European securities markets.
- T2S has removed barriers and eliminated differences between domestic and cross-border settlement by offering a single market infrastructure solution.
- DvP is a securities industry settlement procedure in which the buyer's payment for securities is due at the time of delivery.

TARGET2-SECURITIES *(cont)*

- DvP is a settlement system that stipulates that cash payment must be made prior to or simultaneously with the delivery of the security.
- After market consultations and a decision by the European Central Bank (ECB) Governing Council, the T2S project was launched in 2008 and the platform became operational on 22 June 2015.
- The T2S Framework Agreement, negotiated between CSDs and the Eurosystem, has been signed by over 20 CSDs, which will migrate to the T2S platform in five waves between June 2015 and September 2017.

TARGET2-SECURITIES *(cont)*

- T2S itself is not a CSD; it is a platform which enables CSDs to increase their competitiveness.
- T2S also enables non-euro area central banks to connect to T2S with their currencies.
- The T2S platform allows DvP settlement in central bank money in any of the available currencies.
- For the time being, Denmark is the only non-euro area country which will make its currency available for settlement on T2S.

Purpose

- The fundamental objective of the T2S project is to integrate and harmonise the highly fragmented securities settlement infrastructure in Europe.
- It aims to reduce the costs of cross-border securities settlement and increase competition and choice among providers of post-trading services in Europe.
- It is therefore a critical step forward in the creation of a true single market for financial services in the EU.

Running T2S

- The development and operation of T2S was assigned to four Eurosystem central banks – those of France, Germany, Italy and Spain.
- The project is coordinated by the ECB and run on a cost-recovery basis.
- The information technology (IT) platform itself is owned and operated by the Eurosystem to ensure it is resilient and stable.

Running T2S *(cont)*

- Settlement in central bank money is a very important feature that eliminates settlement risk – this can only be offered by central banks;
- As a supranational framework, the Eurosystem is neutral towards all EU countries and stakeholders;
- he Eurosystem has no economic interest and only works towards full cost recovery;
- The Eurosystem has experience in successfully designing and implementing Europe-wide financial infrastructures, such as TARGET and TARGET2.

Running T2S *(cont)*

- **All relevant stakeholders affected by the project are closely involved in the governance of T2S.**
- **The Market Infrastructure Board is the main body tasked by the ECB's Governing Council with the management of the T2S project and the relationship with market stakeholders.**

Objectives and benefits

- As one of the largest infrastructure projects launched by the Eurosystem to date, T2S brings substantial benefits to the European post-trade industry.
- Cost-reduction: One of the objectives of T2S is to reduce the cost of securities settlement in Europe, in particular for transactions across EU countries, which can be ten times more expensive than domestic transactions;

Objectives and benefits *(cont)*

- **Deepening market integration:** The T2S settlement engine also brings us a step closer to a single market for financial services and deeper financial integration in Europe.
- Furthermore, T2S has harmonised post-trade practices across Europe;
- **Improving collateral management:** The platform also helps banks optimise their collateral and liquidity management by creating a single pool, essentially ensuring that collateral is not blocked in local markets but can quickly be moved to where it is needed.

Objectives and benefits *(cont)*

- Because of reduced settlement costs, increased competition and greater harmonisation, T2S is expected to have a positive impact on European economic growth.
- The lower costs of settlement can be passed on to investors.
- By making it easier and less costly to access securities in other EU countries, investors can now hold more diversified bond and equity portfolios.
- In addition, issuers have access to a more diversified investor base.

Objectives and benefits *(cont)*

- The T2S platform may also increase financial stability in the long run.
- It will reduce the risks that still affect the settlement of cross-border transactions.
- With its robust business continuity solution and settlement in central bank money, it helps decrease counterparty and settlement agent risk.
- By fostering greater efficiency and integration of European financial markets, T2S may lead to greater diversification and sharing of risks, adding to the stability of the whole system.

Objectives and benefits *(cont)*

- Due to the "lean T2S" concept, which facilitates post-trade activities, banks will be able to streamline their back offices and thus reduce costs.
- As T2S separates the settlement infrastructure from the services offered by central securities depositories, competition in the provision of these services has increased, and will continue to increase, to the benefit of customers across Europe.

Objectives and benefits *(cont)*

- **T2S offers settlement of securities and cash in central bank money – a service that is not readily available elsewhere.**
- **Securities accounts and cash accounts are integrated, making settlement fast, highly efficient and low risk.**
- **T2S accommodates market participants' securities accounts, held at one or more CSDs, and their dedicated central bank cash accounts.**

Objectives and benefits *(cont)*

- CSDs keep their clients' positions in T2S, each securities account is attributable to a single CSD and each cash account is assigned to a single central bank.
- Dedicated cash accounts are linked to market participants' main cash accounts in TARGET2 or another non-euro real-time gross settlement account.

Objectives and benefits *(cont)*

- The use of an "integrated model" allows T2S to connect any securities account at any participating CSD with any cash account at any participating central bank.
- Settlement instructions are matched by T2S and DvP settlement is carried out in real time.
- T2S is a state-of-the-art platform that offers a set of advanced, highly sophisticated technical features, including high-tech optimisation algorithms to enhance settlement efficiency and advanced auto-collateralisation mechanisms.

BCBS MARGIN RULES

- Since 1 September 2016, new initial margin (IM) and variation margin (VM) requirements for non-centrally cleared over-the-counter (OTC) derivatives have been introduced and applied to jurisdictions globally.
- These new margin rules originate from a global policy framework and timetable that was published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO).

BCBS MARGIN RULES *(cont)*

- They are a key part of the reform agenda put in place by the Group of Twenty (G20) as a response to the 2008 financial crisis and seek to reduce systemic risk in the non-centrally cleared OTC derivatives markets by ensuring appropriate collateral is available to offset losses caused by the default of a counterparty.
- Important: Although the implementing jurisdictions' margin rules are based on the same global policy framework there will invariably be differences in each jurisdiction's requirements.

Variation margin in a nutshell

- Variation margin reflects the daily change in market value of the financial instruments.
- Two counterparties must exchange VM to cover their current exposure based on the valuation of the financial instruments they are trading.
- These daily valuations (also known as 'mark-to-market') and the calculations follow transparent and well recognised industry methodologies.

Variation margin in a nutshell *(cont)*

- The variation margin rules apply to trades between the largest market participants since 1 September 2016 (in the US, Canada and Japan).
- Since 1 March 2017, VM has applied to all other in-scope entities (subject to jurisdictions' implementation schedules).
- Once the new margin rules are effective, the number of counterparties that will need to exchange VM will significantly increase.

Variation margin in a nutshell *(cont)*

- To ensure regulatory compliance, all affected counterparties will have to undertake a substantial repapering exercise to put new collateral documents in place or to update existing collateral documents.
- Affected counterparties will also need to have the capacity to operationally exchange VM.

Variation margin in a nutshell *(cont)*

Variation margin may not be a new process but:

- **it will be mandatory for all in-scope entities;**
- **new regulatory requirements will apply; and**
- **new regulatory compliant documentation will need to be completed.**

Variation margin in a nutshell *(cont)*

- Daily exchange of variation margin became mandatory for major market participants from 1 September 2016 and for all other in-scope entities since 1 March 2017 (subject to jurisdictions' implementation schedules).
- Since 1 September 2016, in-scope entities that belong to a group whose Aggregate Average Notional Amount (AANA) of non-centrally cleared derivatives for March, April, and May 2016 exceeds EUR3 trillion are required to exchange variation margin when transacting with one another.

Variation margin in a nutshell *(cont)*

- This initial compliance date applies to a few of the largest market participants.
- From 1 March 2017, all in-scope entities in certain jurisdictions, regardless of their AANA, will be required to exchange VM.
- This requirement only applies to new contracts entered into on or after 1 March 2017.

Initial margin in a nutshell

- IM is an amount of collateral that investors post to enable trading in financial instruments. Posting of IM aims to reduce the broker's exposure to the investor's credit risk.
- Whilst there is a common process for exchange traded and cleared derivatives, this is largely a new process for uncleared OTC derivatives.
- The IM obligation started on 1 September 2016 in United States, Canada and Japan for a few of the largest market participants only.

Initial margin in a nutshell *(cont)*

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Initial margin in a nutshell *(cont)*

- The IM obligation for the vast majority of the in-scope entities will follow a phased-in implementation calendar between 1 September 2017 and 1 September 2020.
- The amount of IM that must be collected and posted will be calculated in accordance with approved margin models that meet defined criteria described within each jurisdiction's final regulatory rules.
- Transfers below a Minimum Transfer Amount (MTA) are not required.

Initial margin in a nutshell *(cont)*

- For instance, under the EU regime, there is a minimum amount of EUR500,000 which may be shared across VM and IM.
- A lower MTA may be set where multiple jurisdictional rules apply in order to remove the inherent risks where the MTA is expressed in a different currency to that of the applicable rule.

Initial margin in a nutshell *(cont)*

- Additionally, an in-scope entity is not required to post or receive initial margin until a consolidated threshold at a group level of EUR50 million IM is reached with its counterparty's group.
- In practice, counterparties' groups will each allocate this EUR50 million IM threshold across their group's entities and versus defined counterparties.

What are the AANA Thresholds and subsequent in-scope dates for initial margin?

- IM will be phased in based on the amount of the counterparty's group AANA of uncleared OTC derivatives for the months of March, April and May of the year when the obligation applies to them.

- Since 1 September 2016 in the United States, Canada and Japan, only entities within large financial groups, which have large aggregate portfolios of uncleared OTC derivatives, have been in-scope for both initial margin and variation margin.

In-scope entities

- Financial firms and systemically important non-financial entities are generally in-scope and may need to exchange VM on a bilateral basis or to post IM to a third-party custodian.
- Each jurisdiction will set forth detailed definitions of in-scope, out-of-scope and exempt entities.
- Margin will not be required to be exchanged with all counterparties.

In-scope entities *(cont)*

- **For example, many jurisdictions' rules will not require the exchange of margin with certain types of non-financial entities (e.g. non-financial counterparties below the EMIR clearing threshold in the European Union).**
- **It is also expected that certain entities (e.g. sovereigns, and central banks) will be exempt.**

In-scope transactions

- New margin requirements will apply to non-centrally cleared OTC derivatives, which are derivative transactions that are not cleared through CCPs.
- There are some product exemptions, as well as exemptions for certain inter-affiliate transactions; however, these exemptions may vary across jurisdiction.

Revised Payment Service Directive

- The European Commission has set out the legislative framework for the new directive and has tasked the European Banking Authority (EBA) to define the standards for the implementation of Revised Payment Service Directive (PSD2).
- The revised Directive on Payment Services (PSD2) has been adopted by the European Parliament in October 2015 and by the European Council of Ministers in November 2015.

Revised Payment Service Directive *(cont)*

- The PSD2 aims at enhancing consumer protection, promoting innovation and improving the security of payment services within the EU.
- It was published in the Official Journal on 23 December 2015 and entered into force on 13 January 2016.
- EU member states had until 13 January 2018 to implement it into national laws.

Key aspects

- **Extension of regulated transactions:** Scope of regulated transaction has been extended to transactions in any currency and 'one leg out' transactions.
- **Stricter customer authentication:** Payment Service Provider (PSP) are obliged to ensure a stricter customer authentication every time the payer accesses his payment account online, initiates electronic remote payment transactions or performs any other action through remote channels.

Key aspects *(cont)*

- **Internal dispute resolution:** Execution and application of adequate and effective complaint resolution procedures setting out maximum processing time for the resolution of customers' complaints.
- **Payment initiation services:** PSD2 regulates payment initiation service providers (PISPs) and the initiation of payments. In this context, PSPs domiciled in the EU are obliged to provide secure communication facilities, inform PISPs about payment initiation, and treat all initiated payments equally.

Key aspects *(cont)*

- **Account information services:** The access to the payment service user's account has to be granted to third party providers for account information aggregation services.
- PSD2 regulates the duties of the account information service providers and those of the PSPs.

Main PSD2 objectives

- **Enhance the prerequisites for a single, efficient European payments market for retail payment transactions and contribute to a more integrated and efficient European payments market, reducing market deficiencies, exemptions and creating the prerequisites for the digitization of the payments industry.**
- **Improve the level playing field for all payment service providers (including new players) and, consequently, encourage competition as well as build the foundation for equal opportunities of all payment service providers.**

Main PSD2 objectives *(cont)*

- Increase scope of directive by including not yet regulated payment service providers, not yet regulated transactions and reducing exemptions.
- Increase customer protection as well as security and safety of payments by means of increasing transparency, efficiency and security of retail payments (e.g., stricter authentication mechanisms) as well as allocating obligations and liabilities to the involved stakeholders.

Main PSD2 objectives *(cont)*

- Reduce the overall costs in the payments value chain, especially by increasing competition, encouraging lower prices for customers and setting baselines.
- The major changes to the existing payment services directive (2007/64/EG) are visualised in the figure below.
- These changes are not exhaustive and have been categorised for a better understanding.

PSD2 Framework

PSD2

Complaints Management

- Standardization of internal complaints management processes
- Deadlines for complaints resolution

Consumer protection

- Obligation to inform on payment initiation service fees
- Liability with regard to unauthorized transactions
- Refund right with regard to SDD

Transparency

- Central access point for payment services at EBA (information on registered payment services of PSP)

Access to infrastructure

- Regulation of payment initiation services (provider)
- Regulation of account information services (provider)

Security

- Security requirements (network and information security directive)
- Security mechanism and stricter consumer authentication
- Reporting of security incidents (EBA)

Scope

- Geographical & currency extension regarding regulated transactions
- Inclusion of third party providers
- Clarification and extension of definition

Third party access

- Under PSD2, third party providers (TPPs) will be granted consented access to customer information through the banks' infrastructure to deliver new value-added services.
- Given the strategic and operational impact of this change, there has been wide speculation on how the access-to-account (XS2A) mechanism would work, and concerns echoed around malware attacks, fraud propensity and data privacy (driven by the General Data Protection Regulation).

Third party access *(cont)*

- To enable XS2A with, banks are required to offer a communication interface for TPP requests.
- This TPP interface should have the same functionality and deliver the same level of support as for customers transacting directly with their bank.

Third party access *(cont)*

- The European Banking Authority has suggested the use of ISO 20022 as a potential candidate for the interface format but the RTS does not provide any prescriptive guidance on how exactly XS2A is to be implemented.
- Whilst there are no regulatory-defined interface formats yet, several industry consortia such as the Berlin Group and the UK's Open Banking Working Group have published proposed interface templates that banks can use as a baseline.

PSD2 Timeline

Time	Term
June 2013	First proposed by EC. As a replacement to the original payment service directive.
2014	Detail prepared by the EC. To take into account new method of payments that have come to market.
8 October 2015	PSD2 becomes official. Adopted by European Parliament.
8 December 2015	EBA begins industry consultation on security and strong auth.
23 December 2015	PSD2 is published in the Official journal of EU.
12 January 2016	PSD2 Effective. Entry into force.
8 February 2016	Deadline for EBA consultation.
Q2:2016	Draft EBA RTS on security and strong auth.
November 2017	EBA Security and Auth RTS. EC adopted the RTS.
13 January 2018	Deadline for national governments to transpose PSD2 into local legislation.
September 2019	EBA Security and Auth RTS. Entry into force.

DODD-FRANK VOLCKER RULE

- The legislation known as the Volcker Rule was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and codified in Section 13 of the Bank Holding Company Act of 1956, as amended (BHC Act).
- The Volcker Rule generally prohibits, subject to exceptions, a banking entity from engaging in proprietary trading and from acquiring or retaining an ownership interest in or sponsoring a hedge fund or private equity fund.

DODD-FRANK VOLCKER RULE *(cont)*

- Certain trading and fund activity is expressly permitted – notably, underwriting activities, market making-related activities, and risk-mitigating hedging activities.
- The Volcker Rule legislation covered the area with a broad brush, leaving many significant issues open to regulatory interpretation.
- In December 2013, five federal financial regulatory agencies (collectively, the Agencies), adopted a final rule (Final Rule) construing the Volcker Rule.

DODD-FRANK VOLCKER RULE *(cont)*

- The Final Rule also sets out a compliance and reporting regime for banking entities engaged in proprietary trading or fund sponsorship or investment.
- The determinations made by the Agencies in the Final Rule reflect two years of comment and debate following the issuance of a Proposed Rule (Proposed Rule) in November 2011.
- Under the Final Rule, larger banks and bank affiliates (based on total assets) that are engaged in proprietary trading permitted by the Final Rule will be subject to a compliance regime to ensure compliance with the Final Rule.

DODD-FRANK VOLCKER RULE *(cont)*

- Under the Final Rule, larger banks and bank affiliates (based on total assets) that are engaged in proprietary trading permitted by the Final Rule will be subject to a compliance regime to ensure compliance with the Final Rule.
- In addition, larger banks and bank affiliates (in terms of the amount of their trading assets and liabilities) that are engaged in proprietary trading permitted by the Final Rule will be required to report a highly technical set of quantitative measures.

DODD-FRANK VOLCKER RULE *(cont)*

- Banking entities with only a “modest” level of trading and fund investment activities will be subject to a much less comprehensive set of compliance requirements.
- The compliance requirements are discussed in more detail below.

DODD-FRANK VOLCKER RULE *(cont)*

- The Final Rule is complex in scope and has already elicited significant commentary and questions from the banking industry and the public at large.
- The purpose of this guide is to discuss the requirements of the Final Rule at a practical level.

DODD-FRANK VOLCKER RULE *(cont)*

- **While the relevant components of the Final Rule are addressed here, financial institutions should consider all of the Final Rule's "fine print" – the many detailed definitions and conditions that comprise the Final Rule (as well as the extensive commentary contained in Attachment B to the Final Rule) – before making any decisions regarding compliance.**

DODD-FRANK VOLCKER RULE *(cont)*

- **The Volcker Rule, as construed by the Final Rule, has special application to foreign banking organizations that have U.S. bank subsidiaries or operate branches, agencies or commercial lending company subsidiaries in the United States (FBOs).**

The Conformance Period

- The Final Rule is effective April 1, 2014, but the compliance period during which banking entities must conform their activities to the Volcker Rule has been extended for one year until July 21, 2015.
- Nonetheless, effective June 30, 2014, the largest banking entities (those with $50 billion or more in consolidated trading assets and liabilities, as discussed further below) are required to report quantitative measurements to regulators.

The Conformance Period *(cont)*

- The Federal Reserve Bank emphasized in its order approving the extension of the conformance period that each banking entity is expected to engage in good-faith efforts, appropriate for its activities and investments, that will result in conformance with the Volcker Rule not later than the end of the conformance period.

The Conformance Period *(cont)*

- Moreover, banking entities should not expand activities or make investments during the conformance period with an expectation that additional time to conform those activities or investments will be granted, and banking entities with stand-alone proprietary trading operations are expected to promptly terminate or divest such operations.

Banking Entities

- The Volcker Rule applies to "banking entities." A "banking entity" includes:

(1) any insured depository institution;

(2) any company that controls an insured depository institution (in other words, any bank holding company or savings and loan holding company);

(3) any FBO; and

(4) any affiliate of the foregoing. The term "affiliate" is used as defined in the BHC Act and thus includes any company controlled by a banking entity.

Banking Entities *(cont)*

- Notwithstanding the breadth of the definition of a "banking entity," there are certain specific exceptions.
- For example, a "banking entity" does not include a covered fund that is not itself a bank holding company or an FBO.
- This is an important exception.
- A bank holding company that serves as the general partner of a fund would be deemed to control that fund.
- But for this exception, the "covered fund" would itself be a "banking entity" subject to the Volcker Rule.

Banking Entities *(cont)*

- In addition, a “banking entity” does not include a portfolio company held by a bank holding company or an FBO under the so-called BHC Act’s merchant banking authority, a company controlled by an insurance company affiliate of a bank holding company, or any portfolio concern that is controlled by a small business investment company, as defined in Section 103(3) of the Small Business Investment Act of 1958, as long as the portfolio company or portfolio concern is not itself an insured depository institution, a bank holding company or savings and loan holding company, or an FBO.

Packaged Retail and Insurance-based Investment Products

- The PRIIPs Regulation aims to improve retail investor protection by:
- Providing basic pre-contractual information via the introduction of the Key Information Document (KID);
- Improving the quality and comparability of information on the key features of investment products (in particular on risk, performance and costs).

Packaged Retail and Insurance-based Investment Products *(cont)*

- The Regulatory Technical Standards (RTS), published in February 2017 define:

(1) The uniform presentation of information in the KID to achieve comparability across different types of investment products;

(2) A methodology to harmonise the calculation of the summary risk indicators, performance and costs.

- The PRIIPs regulation entered into force on 3 January 2018.

Scope

- The PRIIPs Regulation includes the following investment products:

(1) Non-insurance based investment products (where the amounts repayable to the investor are subject to fluctuations because of exposure to reference values or to performance of assets which are not directly purchased by the investor), Undertakings for Collective Investment in Transferable Securities (UCITS), retail alternative investment funds (AIFs), derivatives, structured securities (such as convertible bonds), pension products and annuities that are not recognised in national law as retirement products, and structured deposits;

Scope *(cont)*

(2) Insurance-based investment products (where these allow for fluctuating pay-outs on maturity or early exit): with profit or life insurance contracts with variable bonuses, or which contain unit-linked and index-linked life elements;

(3) Instruments issued by securitisation Special Purpose Vehicles (SPVs).

Scope *(cont)*

- PRIIPs manufacturers/issuers must draw up a KID for each product in scope. The KID is to be published on the company website prior to the product being made available to retail investors.
- The KID is to be a clearly worded 3-page document, which provides investors with a simple overview of the most important details of the product they are buying including general description of the product, cost, risk profile and possible performance scenarios.
- Any distributor or financial intermediary, who sells or provides advice about PRIIPs to a retail investor or receives a buy order on a PRIIP from a retail investor, must provide the investor with a KID.

Industry implications

- The scope of market players impacted as PRIIPs' manufacturers is broad and includes asset managers, insurance companies, corporates, banks and futures exchanges.
- At a minimum the following aspects need to be addressed by distributors and manufacturers:
- The distribution process and the respective liabilities of the manufacturer and adviser/seller;

Industry implications *(cont)*

- Marketing issues – in particular how to ensure the risk profile and the cost indicators are suitable for the target market;
- Defining the content, given the lack of space in the KID (three sides of A4-sized paper);
- The production, dissemination and update of the KID;
- The transparency requirements that may overlap between PRIIPs and MiFID II.

Industry implications *(cont)*

- **Apart from having to condense the main features of the product into a restricted space, the main challenge for manufacturers is to determine and to review on a regular basis:**
- **The four future performance scenarios;**
- **The summary risk indicator;**
- **The costs indicator, which includes implicit transaction costs.**

PRIIPs Timeline

Time	Term
November 2014	Publication of the Level 1 text in the Official Journal.
June 2016	Adoption and publication of RTS by the EC.
September 2016	Rejection by the EU Parliament of the draft adopted by the EC.
November 2016	The EC extends the application date of the PRIIPs regulation by one year.
Q1:2017	Publication of the revised RTS.
January 2018	Entry into application of PRIIPs.
End 2018	Review of some aspects of the PRIIPs regulation.
End 2019	Entry into application for UCITS and investment funds which already apply UCITS KIID rules.

CANADA DERIVATIVES TRADE REPORTING

- In September 2009, G20 Leaders made a number of commitments regarding the operation of over-the-counter (OTC) derivatives markets, including the statement that all OTC derivatives contracts should be reported to trade repositories in order to improve financial market transparency, mitigate systemic risk and protect against market abuse in the OTC derivatives markets.
- The Canadian Securities Act represents a key step towards the government of Canada's commitment to establish a Canadian securities regulator.

CANADA DERIVATIVES TRADE REPORTING *(cont)*

- **Canada is made up of 10 provinces, each with different securities laws.**
- **Much like a pre-MiFID Europe, there is fragmentation across markets and a need for a harmonised, single framework and increased transparency across derivatives markets.**
- **The derivative trade reporting rules were proposed, updated and finalised by Canadian provincial securities regulators working under a collaborative identity as the Canadian Securities Administrators (CSA).**

CANADA DERIVATIVES TRADE REPORTING *(cont)*

- The CSA was set up due to G20 commitments to establish a new regulatory regime relating to the trading of OTC derivatives in Canada; the CSA addresses trade repositories and derivatives data reporting.
- The derivatives reporting regulation applies to all 10 provinces in Canada, however, there is a need for local adaptation of the regulations in each province due to differences in securities laws.
- This regulation will affect any counterparty to an OTC derivatives trade.

CANADA DERIVATIVES TRADE REPORTING *(cont)*

- However, reporting is unilateral and double-reporting should be avoided by prescription of the regulator.
- This results in designation of reporting obligation on a case-by-case basis.
- In a similar fashion to MiFID and EMIR in the EU, a counterparty can delegate it's reporting obligation to either it's counterparty or a third-party service provider.

Key points

- The Canadian derivatives reporting regulation has two main components:

(1) Scope rule

- Define types of derivatives that will be subject to reporting requirements under the TR rule.
- Exemptions include but are not limited to:
  - Gaming and insurance contracts regulated by a domestic or an equivalent foreign regulatory regime;

Key points *(cont)*

- currency exchange contracts provided that the contract:
  - Settles within prescribed timelines;
  - Is intended by the counterparties to be settled by delivery of the currency referenced in the contract; and
  - Is not rolled-over;
- Commodity forward contracts provided that physical delivery of the commodity is intended, and the contract does not permit cash settlement in the ordinary course.

Key points *(cont)*

(2) Reporting Obligation

- Reporting of derivatives to a trade repository is unilateral; the TR rules outlines a hierarchy for determining which counterparty will be required to report a transaction.
- Trade reporting is to be completed on a real-time basis. However, where it is not technologically possible to do so, the reporting counterparty must report as soon as possible but not later than T+1.
- Transactions that were entered into prior to the TR Rule coming into force will be required to be reported provided they have not expired or been terminated within a prescribed period after the TR Rule comes into force (31st December 2014).

Key points *(cont)*

- Three main types of data must be reported under the TR Rule:
  - Creation data;
  - Life-cycle event data, including any amendments to derivatives data previously reported or novation;
  - Valuation data which includes the current value of the transaction.

Canada Derivatives Timeline

Time	Term
31 October 2014	The effective date of the reporting obligation for derivatives dealers and recognised or exempt clearing agencies (changed from July 2, 2014).
30 April 2015	Public dissemination of transaction-level reports (changed from December 31, 2014).
30 April 2015	The latest date by which a derivatives dealer or a recognized or exempt clearing agency must report a pre-existing transaction (one which entered into has outstanding contractual obligations as of October 31, 2014).
30 June 2015	The effective date of the reporting obligation for all other reporting counterparties (changed from September 30, 2014).
31 December 2015	The latest day by which a counterparty that is not a derivatives dealer or a recognized or exempt clearing agency must report a pre-existing transaction (one which has outstanding contractual obligations as of June 30, 2015).

Hong Kong Monetary Authority Market Reform

- The Hong Kong Monetary Authority (HKMA) is the government authority in Hong Kong responsible for maintaining monetary and banking stability.
- Its main functions are:
- maintaining currency stability within the framework of the Linked Exchange Rate system;

Hong Kong Monetary Authority Market Reform *(cont)*

- promoting the stability and integrity of the financial system, including the banking system;
- helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure; and
- managing the Exchange Fund.

Introduction to HKMA's market reform

- Following the G-20 commitment to improve transparency and risk mitigation in the financial markets, a process of extensive regulatory change began across the Asia-Pacific region.
- In 2011 and 2012, the HKMA and Securities and Futures Commission (SFC) consulted the market on a proposed regulatory regime for the Over-The-Counter (OTC) derivatives market.

Introduction to HKMA's market reform *(cont)*

- The Joint Supplemental Consultation, issued in July 2012, set out in more detail the scope of dealing, advising and other activities to be regulated under the new regime.
- The consultation also set out proposals for regulating the activities of persons whose positions are so large as to raise concerns about systemic risk (i.e. systemically important participants).

Introduction to HKMA's market reform *(cont)*

- To comply with strict international standards, the new regulatory regime focused heavily on the OTC derivatives markets, including reporting of specified OTC derivatives transactions to the Hong Kong Trade Repository (HKTR), clearing of specified transactions at designated Central Counterparties and margining of non-cleared derivatives.
- The Hong Kong Trade Repository will also provide services for trade matching and confirmation.

Supervision in line with Basel III

- The HKMA seeks to establish a regulatory framework in line with international standards, in particular those recommended by the Basel Committee on Banking Supervision.
- The objective is to devise a prudential supervisory system to help preserve the general stability and effective working of the banking system, while at the same time providing sufficient flexibility for authorised institutions to take commercial decisions.

Hong Kong Monetary Authority

HKMA's market reform and its impact on market participants

- **These new requirements impact market participants in most Asian countries, including Hong Kong, Australia, Singapore and Korea.**

Margining of non-centrally cleared derivatives and risk mitigation standards

Margining of non-cleared derivatives

- In keeping with its commitment to implement the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (BCBS-IOSCO) framework for non-centrally cleared derivatives, the HKMA introduces margin and risk mitigation standards for non-centrally cleared OTC derivatives in its Supervisory Policy Manual.

Margining of non-centrally cleared derivatives and risk mitigation standards *(cont)*

Margining of non-cleared derivatives

- The requirements enter into effect on 1 March 2017 with a six months' transition period for VM and a scheduled phase-in of initial margin IM based on OTC derivative exposure consistent with the international standard.

Margining of non-centrally cleared derivatives and risk mitigation standards *(cont)*

The Initial and variation margin and risk mitigation rules apply to:

- Hong Kong incorporated AIs, irrespective of where their trades are booked, and
- Overseas incorporated AIs with respect to trades booked in its Hong Kong branch only when they enter into in-scope non-centrally cleared derivatives with a Covered Entity.

Margining of non-centrally cleared derivatives and risk mitigation standards *(cont)*

- Covered entity refers to financial counterparties and significant non-financial counterparties which are not excluded entities.

Exempt non-centrally cleared derivatives

- Physically-settled FX forwards and swaps, physically settled commodity forwards and FX transactions embedded in cross-currency swaps associated with the exchange of principal are exempt from VM (and IM) requirements.
- Significant non-financial counterparties that use non-centrally cleared derivatives predominantly for hedging purposes are not required to exchange IM and VM.

Exempt non-centrally cleared derivatives *(cont)*

Substituted compliance

- **Substituted compliance is available for cross-border transactions with:**
- **Australia, Canada, the European Union, India, Japan, Republic of Korea, Mexico, Russia, Singapore, Switzerland and the United States, which are deemed comparable jurisdictions until HKMA has completed a comparability assessment, and**
- **Jurisdictions for which the HKMA has issued a comparability determination.**

Exempt non-centrally cleared derivatives *(cont)*

Non-netting jurisdictions and non-segregation jurisdictions

- Exchange of margin is not required when Covered Entities trade with counterparties located in non-netting jurisdictions or non-enforceable collateral jurisdictions.
- Instead, they are required to put in place appropriate internal limits and risk management policies and procedures.

Risk Mitigation Standards

- HKMA has issued Risk Mitigation Standards (RMS) to promote legal certainty over the terms of the non-centrally cleared OTC derivatives transactions, foster effective management of counterparty credit risk and facilitate timely resolution of disputes. These rules rely on:
- Execution of written trading relationship documentation;

Risk Mitigation Standards *(cont)*

- Confirmation of the material terms of the non-centrally cleared OTC derivative after the transactions are executed;
- Valuation of non-centrally cleared derivatives in an objective manner;

Risk Mitigation Standards *(cont)*

- Regular reconciliation of the material terms and valuations of all transactions in a non-centrally cleared derivatives portfolio; and
- Resolution of disputes in a timely manner.

HKMA published the final rules in **Q4 2014**.

ABOUT STORM-7 CONSULTING

Storm-7 Consulting are a financial consultancy company that provides premier financial intelligence and knowledge to leading financial institutions around the world. We deliver premium quality conferences on cutting-edge legal and financial issues, and strive to provide access to crucial insight by leading experts on the latest complex regulatory developments.

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A GLOBAL REGULATORY SNAPSHOT

SESSION 2

TRAINING COURSE
A GLOBAL REGULATORY SNAPSHOT
2018

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