RegTech

Guiding your way through global regulatory storms

In partnership with JWG
Making sense of financial services regulation

APRIL 2013

Jumping through hoops

Regulators are looking for proof that firms are meeting data requirements

HOW DOES YOUR RISK DATA LOOK?

Answering questions on global risk data requirements might be difficult without a timely self-assessment

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AMLD IV

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Proof reading

There's a branch of mathematics called proof theory, concerned with the provability of proofs. It's one of those areas of maths that blows your mind if you are not an actual mathematician.

Many people in IT will have come across the concept reading Douglas Hofstadter's *Gödel, Escher, Bach: an Eternal Golden Braid,* which was published in 1979, just as the PC revolution was starting. Like *A Brief History of Time,* many people had it on their bookshelves.

Kurt Gödel, a logician and mathematician, was central to the development of proof theory. His main work was called the incompleteness theory, and it may have some relevance to some of the latest regulatory demands faced by financial services firms. As the content of this month's RegTech shows, regulators are increasingly demanding that firms not only collect particular sets of information and follow certain processes; they must also be able to "prove" that they are doing so.

Gödel would be a handy man to have around as an expert witness in some of the cases that are likely to come up because of the subjective nature of some of the proofs that will be required. As this month's feature on risk data points out, "there are many nuances in the principles and hence many grey areas".

Grey areas are good for logicians, who can happily think up ways of making them less grey, or formally defining the extent of their greyness. Grey areas are also good for lawyers, because they can earn a lot of money advising clients about the greyness, and more for arguing about it with other lawyers in court.

Grey areas are less good for business, which is why London's insurance market has spent centuries removing ambiguities from its rules. More recently, the international bond markets have been operating on similar lines – there will be conflicts, but there is a defined and respected resolution path.

Looking on the bright side, perhaps we are seeing the start of a similar process. Over time, the grey areas may be thrashed out.

Let's hope so. For now it looks as though the principle of "innocent until proven guilty" is being replaced by "guilty, by reason of being a banker".

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Mirror, mirror: how does your risk data look?

Being ready to answer regulatory questions on how well you meet global risk data requirements might be difficult without a timely self-assessment

Following the release of the Basel Committee on Banking Supervision's Principles for Effective Risk Data Aggregation, middle and back office professionals in major financial centres now find themselves with a number of difficult questions, that senior management must be able to answer and evidence. Many are faced with a collective action problem within their own firm as they try to form a view of where they stand.

In a nutshell, the introduction of these principles means that firms can no longer afford to cut corners. As of January 2013, firms are being pushed to assess how they collect, aggregate and report their data. Though this has always been done in the past, new requirements necessitate fundamental changes to be able to prove that both their current and future target operating models are understood, resourced, owned and governed properly.

So how ready are we to look into the risk data mirror and be satisfied with the result? Existing research shows that firms are at varied stages of preparedness. For instance, in a 2012 IIF survey, only 28% of firms surveyed said that data aggregation plans were complete within their firm. However, this was before the release of the BCBS' Principles and so the number now looks to be even less.

We advocate a strong self-assessment now, to: figure out the size and cost of the problem, and secure budget; to keep up with risk management in the industry, and safeguard reputations; and to take advantage of the efficiencies that can be gained from good data management. For this purpose, firms will need a checklist against which to validate their risk data aggregation capabilities.

Such a checklist should naturally be based upon the requirements themselves. However, this does not mean that the requirements are, in themselves, an adequate checklist. Many of the imperatives allow substantial room for interpretation. So when asked a vague question, such as 'does your board promote the identification, assessment and management of risks to data quality?' the tendency is to answer 'yes, it does'.

But if the question the regulator is asking is 'how do they do this?' or 'do they do it x times a year, or to y standard?' then the answer is likely to be more hesitant. Hesitation is not good: it means that it is quite likely that the principle is 'materially non-compliant' and that significant actions are needed in order to achieve full compliance. Therefore, banks should first determine their own standards for compliance and then assess themselves more meaningfully against these.

There are many nuances in the principles and hence many grey areas. For example, in the governance space, banks are required to 'consider' risk data aggregation as part of any acquisition or divestiture. However, clearly 'consideration' is a broad scale, as are many other critical concepts, in terms of its breadth and depth of coverage.

Even within a more objective discipline like data architecture a similar interpretative challenge is encountered. The principles ask for the monitoring of the accuracy of risk data. This clearly requires some kind of metric capable of judging accuracy. However, again, this can be seen on a scale: from a bare-bones estimate up to a comprehensive measurement.

Part of the self-assessment will therefore involve determining what this scale is for each of the imperatives within the principles, and then placing the firm's target operating model somewhere on that scale. In placing the marker, firms will have to consider many things, including the marginal cost/benefit of moving up the scale, what other firms are doing, and the method of interpretation.

Another key differentiator in the governance example above is in the proof of the action taken. Tacit understanding cannot be verified, whereas a meeting can. Here it is important to note that 'proof' does not simply mean 'auditability'. But, as a result of the principles, both internal staff and regulators will also be checking up on firms' risk data aggregation. Therefore, when answering 'yes' to a question on the checklist, the assessor's first follow-up question should always be 'how can I prove this?'

This proof also will obviously take different forms depending on the context. For instance, any changes made to the governance level will probably rely on documentary evidence. Here, again, firms will have to decide what 'documentary evidence' means to them and where their target operating model is on a scale of different depths of proof.

Sometimes, after a long period of indulgence, it can be difficult to look into the mirror and confirm that your fitness regime has slipped. Firms should take the opportunity they have now to stand before the self-assessment mirror and identify the key changes that need to be made, before the regulators come knocking.

TOP TWITTER ALERTS

- Focus on SIBs: BCBS promises to turn up the heat on banks in 2013 over risk management, governance, and data aggregation
- ESMA issues final remuneration guidelines on #AIFMs including remuneration committee "unfettered" access to risk management data
- Regulation SCI: SEC's new tech rules to replace voluntary compliance program; operational risk high on global agenda

KNOWN UNKNOWNS

- How will firms find the middle ground between the BCBS' Principles for Effective Risk Data Aggregation and other risk data initiatives, such as Basel III and the EDTF?
- What will be the outcome of regulators' visits to firms in 'early 2013'?
- How do firms compare with one another and what does 'good' look like?

THEMES

- Regulators are taking a tougher stance on back office hygiene
- Risk data aggregation is important to supporting other efforts such as RRPs
- Timely self-assessment can save significant work further down the line.

Welcome to EMIR: the known unknowns of customer classification

With EMIR in force, firms are now wrestling with the challenge of classifying their customers – without an industry viewpoint the dialogue could get ugly …

TOP TWITTER ALERTS

- EMIR deadline: ISDA publishes NFC Representation Protocol; allows participants to amend multiple ISDA Master Agreements
- With the first #EMIR deadline looming in 11 days, how will your OTC BAU need to change?
- FSA releases EMIR notification reports for NFCs over the threshold: no group identifiers required?

KNOWN UNKNOWNS

- Will firms' EMIR classifications be 'good enough' for the regulator now?
- Are the current industry solutions fit for purpose?
- How exposed is the industry to mis-classification without industry alignment?

THEMES

- The industry lacks clarity on a common approach to customer classification
- Customer classification differs between regulatory regimes, e.g. Dodd-Frank
- There are no common standards for customer classification across jurisdictions?

EMIR's first implementation date has now been passed. From 15 March, investment firms and corporates will now need to notify ESMA if they have passed the clearing threshold, confirm their uncleared OTC trades and begin preparations to implement EMIR's risk mitigation techniques. In order to do this, you need to know your counterparties' classification; whether they are a Financial Counterparty (FC), Non-Financial Counterparty (NFC), or a NFC over the clearing threshold (NFC+).

Of course, it is not a huge issue to identify a financial counterparty. JWG research shows that 95.6% of commonly used industry codes can be used to identify non-financial counterparties with a high degree of certainty. The real complexity of this classification exercise comes with identifying non-financial counterparties over the clearing threshold. Unlike other regulatory regimes this classification relies on a firm's partial view of the marketplace that may not be shared by others.

For example, a big firm must now make a judgement on whether a large oil company's subsidiary in Paris can be considered to be a NFC when the trade being conducted is likely to put it over the clearing threshold.

Client classification will have a bearing on the timely confirmation of uncleared trades and eventually the clearing of trades subject to the clearing obligation and the correct posting of margin. Failure to correctly classify counterparties or, just as importantly, classification of clients which is different from that of your competitors, may adversely impact a firm's ability to do business.

What's the problem then? Firstly, unlike MiFID, firms cannot rely completely on self-certification. This is because, while there is an EMIR requirement for NFCs to notify authorities when they, or any others in their group, have breached the threshold, there is no such obligation to inform the marketplace of their status. This means that a firm's customer is under no obligation to ensure all its trading partners classify it in the same way. Even the NFC that breaches the clearing threshold (NFC+) is under no regulatory obligation to inform its counterparties – it must only inform its competent authorities and ESMA. And ESMA is under no obligation to share its NFC+ register.

For these reasons, ESMA stated in public forum in Mid-2012 that self-certification of status 'may not be sufficient'. Some take the view that it would be very easy for regulators to leverage this uncertainty to obtain 'easy wins' by finding fault with current approaches in a transparent manner (e.g. through fines, speeches, etc.).

The ISDA Protocol is one attempt to solve the problem of the NFC+ in a legal fashion, but does not attempt to make the initial division between FCs and NFCs. While the contract provides legal certainty on counterparties' status, in that liability for mis-classification lies with the self-certifier, it only focuses on whether or not the threshold has been breached. As such, this may only provide a partial answer.

Many corporates will not be willing to legally self-certify their status. This is due to the complexity of assessing whether they have breached the asset threshold on a group-wide basis. Many do not have the extensive internal monitoring systems required to maintain the accuracy of their classification, especially when they may be in danger of breaching the threshold on a trade-by-trade basis. This means that a large part of the certainty required by a firm will need to be obtained directly.

In addition, it is worth mentioning the British Bankers' Association Data Management Advisory Panel, which has been working on a methodology for using industry codes to classify counterparties on 'day 1'.

The fundamental barrier to a consistent interpretation across Europe is the lack of clarity as to what, exactly, the politicians and regulators meant about what counterparties should know about each other. Did they mean that every firm should know their customer's precise status in intimate detail – including up to the minute knowledge of how much trading they are doing with other firms? Or, did they merely mean that we should have a general understanding of what was likely to be their status based on a profile?

Firms are facing many of the same practical challenges for EMIR as they do for AML, FATCA and a host of other regulations in 2013. This speaks to the larger challenge facing the industry, the inability to get guidance needed to be able to implement requirements in a consistent and cost-effective way.

With a number of regulations requiring changes to the way you classify customers, this is not an issue that is going away anytime soon.

Regulating the -IBORs: a global view of benchmarks?

Europe has made the first move to controlling benchmark manipulation but global co-ordination is needed at this stage to create an approach that works for everyone

Benchmark manipulation and fallout from it is not new news, but the global drive to regulate benchmarks is. The political sensitivity surrounding regulation in this space means that national regulators are racing at different speeds and approaches to implement reforms to ensure benchmarks are transparently regulated and set. As this race continues, global regulators such as IOSCO will be challenged to coordinate local regulators in a concrete benchmark regulation framework.

Politicians are keen to be seen as aggressively holding bankers accountable for an action that contributed to the financial crisis. Putting evidence of poor behaviour in the public domain and levying large fines may well be a path towards a more trustworthy system, but it has led to a rushed and splintered rulemaking process.

Today, EU regulators are leading the race to implement benchmark reforms via market abuse regulation and through a recent joint ESMA/EBA consultation. Globally, IOSCO is still behind, forming a task force and releasing its high-level consultation report on financial benchmarks. The US still has yet to make a move. Clearly, without these major players on the same page, benchmark regulation may remain more a fiction than a reality.

There are many flavours of benchmark that are used for a variety of purposes. At present, there is no concrete definition of a benchmark, so ESMA and the EBA are attempting to create their own. However, where ESMA runs a very abstract definition of a benchmark, IOSCO has taken a more practical approach, in its 2013 consultation, by including a 'use test' that limits the scope. This means that the global, IOSCO, definition of a benchmark would come closer to the conventional usage of the word 'benchmark', whereas the EU definition would include other rates, such as market indices.

Ultimately, there are clear ways to differentiate between indices – for example, the delineation between benchmarks set subjectively (and therefore open to manipulation) and market indices set automatically (and therefore harder to manipulate). As ever, there will be many ways to classify and 'carve out' various types of market activity and we have only just begun to see a discussion of what this will look like.

Fundamental to the benchmark discussion is the 'emperor's new clothes' problem: indices are valid if people believe in them. If the calculation behind a benchmark changes, confidence may not automatically transfer to the new indicator. This creates a risk that someone may decide that the benchmark does not reflect the realities of the market. In this case, we have introduced risk into the system and potentially destabilised it.

The banks and their suppliers will feel the pinch as they need to change massive systems portfolios and data feeds. Thousands of applications, spreadsheets, databases and online web portals would need to be modified to bring legacy systems up to date. On the other hand, the place where the costs are most likely to be felt by end investors is where loan agreements and their like, which were pinned to certain benchmarks (e.g., LIBOR, EURIBOR), are forced to change. This would involve re-evaluating existing contracts, possibly followed by redrafting/termination, in order to rebase the contract on a new benchmark.

Clearly, a one-size-fits-all approach is not going to work in relation to benchmarks. Therefore, based on responses to ESMA's consultation, it appears many firms would like the freedom to take a proportionate, or risk-based, approach. Proportionality would allow firms and market participants to exercise their own judgment when subscribing to benchmarks. And the exercise of this judgment could then be supervised by a regulator.

However, not all jurisdictions buy the idea of proportionality. Many are more likely, given the industry's record of bad practice in the benchmarking arena, to introduce prescriptive rules that remove any room for firms to exercise judgement.

With Brussels just announcing that banking cartels can be fined up to 10% for each of their transgressions – potentially putting more than 30% of a bank's global turnover at risk – things are due to move quickly in this space. The European Parliament is scheduled to debate benchmarks in three months. CFTC and IOSCO have announced a roundtable at the end of February that should help give clarity on what regulation is coming. Ultimately, however, without binding consequences, regulators will fall short of creating the global agenda necessary to rule out a repeat of LIBOR.

TOP TWITTER ALERTS

- Heavy fines coming: EU says benchmark antitrust investigation is nearing final stages, with many banks implicated
- The watchers watched: FSA cleared of major regulatory failure but admits it was slow to respond to LIBOR-rigging
- The UK's Hogg Committee invites would-be LIBOR administrators to submit pre-tender questionnaire

KNOWN UNKNOWNS

- How will the market react to new, untested benchmarks?
- Will regulation come to cover things such as market indices, like the FTSE 100?
- Will US benchmark regulation align with global approaches?

THEMES

- Benchmarks are politically charged and a global issue
- Benchmarks are ubiquitous and entrenched within the financial system
- Global benchmarks will be difficult for a single jurisdiction to regulate

AMLD IV – Prove you're doing it right

The new EU Anti-Money Laundering Directive looks to be a significant step up for firms' KYC and monitoring teams' risk management, systems and controls in 2014

TOP TWITTER ALERTS

- Closer alignment between FATCA and AML requirements? FinCEN is updating FBAR reports to require TINs
- Customer data reviews req? AMLD expands PEP def, harmonises calculation, new disclosure reqs for beneficial ownership

KNOWN UNKNOWNS

- After lobbying, what will the final measures entail?
- Will the directive get the Swiss, British or German finish?
- What standards will be available for defining a risk based approach within the firm?

THEMES

- Anti-money laundering remains a political focus and more fines to come
- The ways firms view their money laundering risk will be updated in their entirety
- New global standards will expand scope of client documentation, checks, and enhanced controls

Anti-Money Laundering systems and controls continue to make news in the wake of the high profile failures of 2012. On 5 February, the proposal for the updated EU Anti-Money Laundering Directive was finally released. The proposal imposes a number of new requirements significantly increasing the scope and volume of firms' KYC processes likely to be required by 2014:

• Fewer due diligence exemptions – regulated institutions are now not always eligible for SDD

• PEP definition includes domestic politicians – PEPs may no longer be automatically high risk

• Disclosure of firms' beneficial ownership - new calculation requirements and disclosures of beneficial owners

• Transaction monitoring thresholds for due diligence have been decreased by 50%

These new requirements will heavily impact customer due diligence meaning the ways firms view their money laundering risk will have to be updated in their entirety. And the burden of proving this has gone up.

Drawing heavily on the extensive review of the 3rd Money Laundering Directive, as well as the 2012 Financial Action Task Force recommendations, the 4th Anti-Money Laundering Directive gold-plates the FATF recommendations in a number of areas with the aim of tightening existing rules and increasing the scope of the risk based approach.

So what does this actually mean for firms? The risk-based approach is designed to be all about proportionality. The more risk, the greater the due diligence done. For financial services, however, it has long been considered that certain categories of client or transaction can be automatically considered to be low risk. Historically this has meant that, for example, a Tier 1 sell-side institution would likely not conduct extensive due diligence with other large, regulated (and therefore assumed to be 'low risk') institutions.

A number of these exemptions have been removed and AMLD IV is requiring firms to challenge the assumption that some categories can be considered low risk without any knowledge to verify that assumption. Judgement is required, and firms will be forced to defend that judgement. It may very well be the case that in the next round of regulatory visits firms will be asked difficult questions about relationships considered low risk for many years that firms will be without evidence for.

The result of this, for many institutions, will be a vast expansion in the number of clients now requiring documentation, checks, and enhanced controls.

The lowered transaction monitoring thresholds will also further increase the scope and volume of due diligence checks required.

However, it's not just these (lack of) exemptions that are increasing focus on a judgement based approach. The new definition of politically exposed persons, that has been amended to include domestic politicians and members of international organisations, has the ability to vastly increase the volumes of accounts requiring due diligence.

While a minor requirement taken in isolation, considering that the application of PEP checks now required for the client base is no longer exempt from automatic low risk status, the cost quickly rises. The identification and subsequent reviews to uncover all new PEPs within firms' client bases, as well as new accounts, will significantly increase the cost, complexity and latency of acquiring customers.

There are still opportunities for cost savings, however. Domestic political exposure doesn't necessarily mean an increased risk of money laundering in-and-of-itself; but PEP checks have now become another indicator of risk to be taken into consideration when making a holistic assessment of a client. Making a holistic assessment, as part of the risk based approach, requires extensive data sources, controls and rules on how to treat data. Implementing this into an automated solution may be tricky.

But it doesn't stop there. New rules on the calculation and disclosure of beneficial ownership add further complexity. New requirements to disclose beneficial ownership mean all firms have to report their own beneficial owners on a continual basis. While this may be very useful for due diligence checks, and will considerably reduce the burden of verification across the industry, the mechanism on how this new information will be made available to all parties is yet unclear. In any case, due diligence systems will have to be altered and third party information providers will need review.

The proposed rules still require formal adoption by the European Parliament and the Council of Ministers. Thus, it is likely that implementation at the national level won't be scheduled until late 2014. Firms will need to start the dialogue now.

AMLD IV means firms will need to know significantly more about their overall client base's business for AML purposes. That may require investment in new staff and monitoring systems. While it may be that firms' customers' risk levels will remain the same, it may be very expensive to prove it.