

Asia Pacific Financial Forum
The Changing Global Regulatory Landscape
Grand Hyatt Hong Kong
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Session 3 - Overview

Opening

Distinguished guests, fellow speakers, ladies and gentlemen – good afternoon. I have been asked to give a brief overview of the state of global financial regulation. In particular, to offer a snapshot of key U.S. and EU reforms that carry with them unintended consequences on certain sectors of our regional economy.

All of us present are aware that the GFC necessitated urgent and sweeping changes to restore the health and resilience of the banking sector. Several years on, these positive steps have also triggered a range of outcomes that may also be seen as detrimental to the growth and development of many emerging markets, Asia notwithstanding.

I will touch on some of these areas today, and highlight briefly how certain financial reform may, **unintentionally, lead to disruptions to liquidity, capital flows and market efficiency**, all harmful to both market participants and the economy as a whole. But rather than dwell on the negative, I will also share with you some positive outcomes that have arisen from close collaboration between the public and private sectors – including how constructive dialogue can generate tangible solutions to ensure **the robust integration of financial markets and the real economy**.

If trade is the engine that drives the global economy, then **trade finance is the fuel that feeds the engine**. Asia accounts for over 36% of global trade¹ and not only drives production and employment, but lifts health and education standards, and raises overall affluence across many emerging nations.

¹ United Nations – International Trade Statistics Yearbook (2013)

Regulatory Reform and Trade

Post-GFC reforms have impacted trade finance in a number of ways. Some examples include **tightening in liquidity, increased regulatory costs and barriers to finance** for trade and manufacturing. For businesses to grow, financing must be readily available. 90% of all trade and business transactions involve some form of credit, insurance or guarantee.²

As we observed in the immediate period post-GFC, USD liquidity stalled. Not only was it significantly less accessible, it was also more expensive³. Banks were becoming **more risk adverse towards smaller enterprises**. As a consequence, it became much more challenging for businesses to secure access to financing, particularly for those that lacked a sound credit history or sufficient documentation for loan processing.

The key trade finance providers in Asia have typically been European banks. But since the GFC, European banks have been deleveraging and, in part, shedding their trade finance assets. Their role in financing infrastructure projects in Asia has also been scaled back considerably.⁴

The gap between **Asia's need for trade and infrastructure financing and what is available from US and EU financiers has therefore widened**. Whilst the Japanese banks have stepped in as a significant source of funding for emerging Asia, the quantification of such an effect is immeasurable in trade dollar and GDP terms.

Recent figures released by the Bank for International Settlements confirm that European Banks have slashed their lending to Australia by more than US\$30b for the year to September. This comes, in part, from **pressure to repatriate capital** to their home markets.

The Basel III effect

Whilst the new capital adequacy and liquidity requirements stipulated by Basel III aim to strengthen the stability and resilience of financial institutions, there has been much debate around the **potential adverse consequences it may have on the cost of credit, trade finance and the real economy**. With Basel III requiring banks to **hold higher levels of capital against asset**

² International Trade Centre – How to access trade finance (2009)

³ Fung Global Institute – Securing Trade Finance for Asia's Future Growth (Nov 2013)

⁴ Norman Chan's Speech – The Future of Asia's Finance (Feb 2014)

classes, institutions would have **less incentive to lend to SMEs given their risk profiles**. Access to financing is now more difficult.

In response to active lobbying by trade groups, the Basel Committee on Banking Supervision (“BCBS”) issued amendments⁵ on the treatment of certain off-balance sheet items. The amendments gave rise to a more favourable leverage ratio thus reflecting the recognition and acceptance of the true nature of trade finance instruments and low likelihood of default. This change **alleviated earlier fears around systemic credit constraints** and was deemed as a positive and sensible move by the private sector. At the same time, however, the issue has not been resolved completely as the **adoption of capital adequacy rules is often jurisdiction-specific**. Some regulators may choose to opt for conservatism and impose more stringent capital buffers than those proposed under Basel III.⁶ Obstacles may therefore still persist.

Attention has also been drawn to the impact on long tenure **infrastructure financing**. The higher capital requirements and Net Stable Funding Ratio (NSFR) proposed under Basel III **raises the cost of holding and funding longer maturing assets**⁷. Banks therefore have lower incentives to hold such assets on their books.⁸ And one cannot forget that risk management solutions used to manage these investments are often effected through long-dated derivative contracts, such as cross-currency swaps⁹. This also adds to further regulatory costs.

In a study that the International Chamber of Commerce (ICC) released in 2014, 84% of export professionals surveyed agreed that Basel III had made them more selective in loan processing, and 69% of banks had increased the price that they charge customers as a consequence of Basel III¹⁰. The heightened level of vetting and risk profiling has led to a more prudent outcome for regulatory compliance, however, the impact of **constrained and costlier lending** to SMEs does hinder the overall development of Asia’s private sector.

⁵ International Chamber of Commerce (ICC) – Basel III Reg Framework Update (Jan 2014)

⁶ Bloomberg – Financial Regulation Asia Pacific Region Special (July 2014)

⁷ Oliver Wyman – Asia Finance 2020 (2013)

⁸ Norman Chan’s Speech – The Future of Asia’s Finance” (Feb 2014)

⁹ Oliver Wyman – Asia Finance 2020 (2013)

¹⁰ International Chamber of Commerce (ICC) – Rethinking Trade and Finance (2014)

AML/KYC – a serious challenge for trade finance

Another regulatory area that has caused several operational challenges to trade finance is AML/KYC. We have all observed local and international authorities clamping down on financial institutions for breaching AML requirements. Fear-instilling fines and penalties north of a billion dollars have further spurred the banking industry to invest considerable resources to tighten their anti-money-laundering controls and infrastructure in order to be compliant.

One of the outcomes of this is the impact on correspondent banking relationships. AML regulation prescribes relatively onerous due diligence processes in respect of respondent banks. In the ICC's 2014 survey, the cost of AML compliance for one counterparty was as high as \$75,000¹¹. Geography is also part of the risk profiling and assessment. For domestic banks in Asia, this could be an issue, particularly where the sovereign risk rating of the jurisdiction is in question. With the cost of complying with **AML rules being labour-intensive and adding a layer of cost, many correspondent relationships have been terminated**. 32% of banks surveyed by the Asian Development Bank (ADB) reported that they have severed relationships because of AML/KYC.¹²

It should also be noted that AML regulation has led some banks to decline individual transactions because of cross-border inconsistencies and confusion about what it means to be "AML compliant" since the rules vary among jurisdictions. Even if individual applications are accepted, the AML risk assessment process consumes time, with SMEs bearing the brunt of these additional costs.

To aid the smaller financial institutions in their financing role, more work could be done to harmonise the AML rules as well as to develop cost-effective solutions. Some ideas have been offered, such as pooling KYC information through **up-to-date databases** in order to reduce cost and manpower. The question is, can stakeholder groups also help to **streamline due diligence processes** so that it can be more efficient and less costly for all?

¹¹ International Chamber of Commerce (ICC) – Rethinking Trade and Finance (2014)

¹² Asian Development Bank (ADB) – Trade Finance Gap, Growth and Jobs Survey (Dec 2014)

Regional Coordination

The collective view from global standard-setting bodies, regulators, the financial services industry and the end-consumer alike points to the necessity for reform. This is not in dispute. The merits of such reform are widely acknowledged and understood, and new rules have become part of ordinary life. With the U.S. and EU spearheading their respective reform agendas, how can Asia – as a region, adopt these initiatives in a way that makes sense to the local economies? How can we align our infrastructure, domestic regulation and operational processes with global standards yet minimise the disruptions to growth?

There has been much debate around the creation of a single ‘Asian voice’. Challenges abound due to the diversity of the geo-political landscape and the varying degrees of economic development across 20 countries. Even so, the incentive for regional regulators to collaborate and ‘speak out’, harmonise rules and minimise regulatory arbitrage and ensure market efficiencies, cannot be understated.

EMIR – an example of a successful outcome

Solid progress has been made in recent times. Due to the concerted efforts of the IOSCO Asia Pacific Regional Committee, the European Commission responded to Asia’s concerns with respect to the European Market Infrastructure Regulations (EMIR) **recognition rules around Asia Pacific CCPs**.

Asian regulators feared that, should Asia CCPs not be recognised by EMIR, this would have a direct impact on EU established financial institutions carrying on business in the Asia Pacific region and the markets they operate in. The IOSCO Asia Pacific Regional Committee, through an open letter addressed to the EC¹³, urged the Commission to **apply greater transparency and a holistic approach to equivalence assessment**. This would not only encourage the CCPs to seek recognition, but also open up a more collaborative dialogue with individual jurisdictions.

In turn, the EU Commission actively engaged with regional representatives and worked with them to achieve a recognition approach that yielded equivalent regulatory outcomes.

¹³ IOSCO Asia Pacific Regional Committee’s Letter to the European Commission (Jun 2013)

The collective lobbying by Asia's regulators secured the **EU's formal recognition of 4 clearing houses in the region** (HK, SG, Australia, Japan) in October 2014.¹⁴ Ongoing dialogue is still underway in other areas, but this first step was significant in that it removed participation barriers by European banks in the local securities markets for these jurisdictions.

Dodd-Frank - underway¹⁵

A similar effort is currently progressing around the CFTC's OTC Derivative Market rules. Some preliminary consequences have unfolded in Asia where non-US trading platforms were having difficulty determining which clients qualify as US persons. This occasionally lead to an outcome where business relationships with US persons/participants were terminated.

These 'ripples in the pond' lead to **market disruptions, fewer hedging opportunities**, and **fragmentation in liquidity** between US persons who are required to trade on Swap Exchange Facilities (SEF) and non-US persons who are not required to do so. **Market inefficiencies** may arise in such circumstances.

In light of these implications, the IOSCO Asia Pacific Regional Committee has been urging the CFTC to reconsider its approach towards SEF registration requirements and availing exemptions to non-US platforms if they are subject to comparable, comprehensive regulation and supervision under their home countries' regimes.

CFTC's issuance of No Action Letters to several Asian clearing houses in early 2014, and subsequent extensions of these letters in Dec 2014 (Australia, India, Korea, HK, Japan), serves as a workable solution, albeit an interim measure. Nonetheless, we remain hopeful that the recent visit by the CFTC's Chairman to Asia is a positive signal of productive dialogue with the region.

¹⁴ Ashley Alder's Speech – ASIFMA Annual Conference (Nov 2014)

¹⁵ IOSCO Asia Pacific Regional Committee's Letter to CFTC (Apr 2014)

Volcker Rule in Asia

The Volcker Rule imposes broad restrictions on proprietary trading and investing in private equity and hedge funds by banks.

Whilst the Volcker Rule is a US centric regulation, its extra-territorial reach may impact a significant number of Asian banks due to the size of their US operations. This places a heavy compliance burden on at least 20 institutions given the size of their consolidated assets.¹⁶

The European Commission, meanwhile, is currently working on a draft of similar guidelines.

These international rules are intended to make banks safer and less likely to need a government bailout. Their impact on Asian markets, however, is less certain at this point in time.

Under Volcker, Asian banks can be exempted from the prohibition against proprietary trading to the extent that the activity is conducted solely outside the U.S. (known as the “SOTUS exemption”). Immediately after the GFC, banks based in the U.S., Europe and Asia cut back their proprietary trading activities. However, using this SOTUS exemption, some Asian financial institutions are considering rebuilding their proprietary trading operations¹⁷, as they can trade more freely than their US bank counterparts.

Volcker may also constrain liquidity in the sovereign bond market as it does not allow banks to trade these Asian bonds freely throughout the region. For example, US banks can trade foreign government bonds on a proprietary basis only if they have a subsidiary located where the bonds originate, such as trading Hong Kong government bonds through their Hong Kong subsidiary. However, US banks typically trade through regional hubs and are unlikely to set up new hubs in every jurisdiction just to trade bonds. This undesirable impact on domestic sovereign debt markets in Asia was highlighted in a letter to the US Regulators from the Executive Meeting of East Asia Pacific Central Banks (EMEAP) on 3 September 2014.¹⁸

¹⁶ http://www.federalreserve.gov/SECRS/2014/September/20140909/R-1432/R-1432_090814_129607_519741932778_1.pdf

¹⁷ <http://www.profitableinvestmenteducation.com/asian-banks-venture-back-to-prop-trading/>

¹⁸ http://www.federalreserve.gov/SECRS/2014/September/20140909/R-1432/R-1432_090814_129607_519741932778_1.pdf

Conclusion

Just to conclude, I will draw upon some remarks offered by Timothy Massad during his recent trip to Asia... “Because the economies of Asia, the United States and Europe are so inter-connected, **we must work together to build a global regulatory framework...**”

On that note, I will hand things back to Shaun...