CONTENTS

4 Opportunity and Knocks
5 Calculating Risk
9 A Tough Act to Follow
12 Rocky Road Ahead
16 The Hard and Fast Rules
18 Reporting for Duty
20 Tech Action
24 Singapore’s Slingshot
26 Insuring Harmony
28 Throwing Off the Shackles
30 Facing the Future
31 The Golden Rule
The financial sector has been facing a tsunami of new regulations, yet there are opportunities for firms that adapt to this changing environment.

The overarching themes of capital, transparency, and governance provide the central narrative for the new global financial regime and regulators continue to calibrate the right balance of ensuring stability, resilience and protection for investors whilst at the same time fostering innovation in markets.

Regulators are also striving to better coordinate their work internationally and a range of equivalence assessments and cooperation agreements have been reached, with more to come in 2016.

In the meantime, Europe has embarked on an unprecedented effort to improve access to capital across EU member states and resolve the fragmentation of European capital markets through the Capital Markets Union initiative.

Constantin Cotzias
Head of Government & Regulatory Affairs, Bloomberg LP
CALCULATING RISK

Basel III’s recent rulings have largely discouraged banks from taking part in higher-risk trading activity, but key questions remain over the setting of a leverage ratio.

The latest round of rules from the Basel Commission on Banking Supervision (Basel III) has, for the most part, had the predictable result of causing banks to focus on business that requires they hold less risky assets with lower capital weights. Analysis of 42 European Banks with global businesses, compiled by the European Banking Federation last year, showed Tier 1 capital ratios were forecasted to increase to 15.2% in 2015, from a 2008 low of 9.6%, based on “higher retail mortgage lending” and “sharp reductions in trading book activities”.

Meanwhile, interbank lending was down, with EU deposits from non-financial institutions at 71.2% of total deposits, up from 62.8% in 2008.

However, the EBF is also claiming that the Basel Commission’s ongoing deliberations regarding flat rate versus weighted capital requirements could create incentives for higher risk trading activity.

Decision time

The debate is over setting a Leverage Ratio, which capital banks would have to hold against the whole of their debt regardless of the overall risk profile of that debt. “It’s certainly correct that as a result of the Basel liquidity requirements, banks have been going into more retail and non-financial deposit holding, in place of holding inter-banks deposits, while also being encouraged to perform more traditional lending over trading activities,” says Tim...
Buelker, senior policy adviser at the EBF.

“But while the capital and liquidity coverage requirements are set now, the net stable funding ratio (NSFR) and leverage ratio, also prescribed by Basel III, are still being assessed by authorities for final implementation.

“The final calibration of the leverage ratio may have significant impact on banks business decisions as it does not distinguish between the different risks of a banks activities.”

However, Adam Litke, global head of risk product at Bloomberg, disputes the EBF’s assessment of the likely effect of the leverage ratio.

“The US has had a leverage ratio for some time,” he says. “It certainly hasn’t meant that US banks engage in less retail activity.”

He adds that while the leverage ratio may, on a stand-alone basis, encourage trading of riskier assets, other rules, such as restrictions on proprietary trading and the higher capital requirements for trading associated with the Fundamental Review of the Trading Book, push in the other direction. It is clear from the way that banks have been reducing their trading staffs that the net effect of new regulation is to discourage trading activities”.

**Forced changes**

As things stand, a leverage ratio of 3% of capital to assets is set to become a requirement of Basel III in 2018. However individual European central banks and other interested bodies have been invited to recommend levels before the Basel Commission’s next publication on the matter in December 2016.

So far the Bank of England has indicated it believes setting a higher ratio, at least for “systemically important” banks.

The EBF’s research showed an average leverage ratio of 2.9% across the 42 banks studied, with 18 institutions below 3%.

Banks have also been forced to make changes to their internal structures and practices as a result of Basel III, along with other European and domestic legislation aimed at reducing systemic risk in financial markets.

“The banking business has undergone far more scrutiny since the arrival of Basel III,” says Ruth Wandhofer, global head of regulatory strategy, Citigroup. “In practice, this means that particularly the large players are managing their overall activities in a way to ensure the overarching objective is achieved, i.e. an efficient balance sheet.

“Significant investments have been made and continue to be made with regard to compliance. For example in the payments business a key focus is to ensure payments are sanction-checked and no violation of anti-money-laundering or anti-terrorist-financing laws can occur.

“This is even more important given the financial and reputational risks associated with being fined in this space.”

**Better handle**

Accenture Finance and Risk Services, which advises institutions on compliance, has also seen “a significant increase in tools and activities focused on improving collateral calculations, including better inputs, using central clearing of counterparties and better collateralization practices”, according to its MD Steve Culp.

“Banks have been developing better capabilities to understand and manage their risk exposure to counterparties, geographies and products,” he adds. “They’re also getting a better handle on data quality control, which helps in improving accuracy in capital calculations.

“Compliance has been adopting more integrated and preventative practices so they can quickly respond once they have detected an issue, or example by investing in data management and predictive capabilities against target scenarios.”

Marshall Bailey, president of the ACI Financial Markets Association, concurs, noting “an increase in costs” at banks based on “greater audit and transparency practices”.

Bloomberg
He says: “Institutions and regulators have recognized the need for more training, education and monitoring of individual behavior and conduct at all levels, from junior traders to executive management.”

Commitment issues
Another risk weighting reduction strategy for banks, in their more traditional lending capacity, is a shift towards loan contracts with uncommitted facility agreements.

A facility agreement sets out the terms on which the bank will make loans to a borrower in the future, on request by the borrower.

In an uncommitted facility, the borrower can ask for a loan and the bank can refuse at its discretion. In a committed facility, the bank is obliged to make the loan provided that the request meets specified conditions.

Steven McEwan, financial institutions partner at law firm Hogan Lovells, says he anticipates banks becoming “reluctantly meaner” in their use of facilities.

“Greater use of uncommitted facilities is expected because such facilities are treated more favourably than committed facilities by the leverage ratio rules.

“For the same reason, I would expect committed facilities to become more expensive. New liquidity requirements will also lead to an increase in the cost of banking facilities and products such as standby letters of credit and guarantees, and perhaps a growth in deposit accounts with longer withdrawal notice periods, since these are treated more favorably by the liquidity rules.”

“Banks’ business has undergone far more scrutiny since the arrival of Basel III”

Ruth Wandhofer, global head of regulatory strategy, Citigroup
Banks are divesting from certain CLOs while waiting for potential amendments to the Volcker rule to pass.

Although US regulators are in the process of reconsidering some of the provisions of the Volcker rule of the Dodd-Frank Act, banks with operations in the US are divesting from investments prohibited by the rule, as they don’t expect that many amendments will be passed.

The Volcker Rule aims to reduce risk-taking by banks by prohibiting certain activities, such as banks investing in private equity or hedge funds with their own funds. As a result, institutions have been working towards the Volcker Rule’s primary deadline of July 21, 2015, to divest themselves of prohibited, or “covered fund”, investments.

The Federal Reserve along with the other Volcker agencies, have provided some limited relief for Covered Funds held by banks prior to December 2013, from July 2015 to July 2017, which is as far as it can extend implementation, except in the case of illiquid funds, where exemption can be given until 2022 on a fund by fund basis.

Meeting obligations
Meanwhile, Bills have been submitted in the United States Congress, to amend the 2010 Dodd-Frank Act, in an attempt to gain an exemption from the requirement, further delaying the requirement for banks to divest from certain Collateralized Loan Obligations (CLOs) that are covered by the Volcker Rule.

CLOs are portfolios of bonds and loans that are packaged and converted into single yield paying notes.

The Volcker rule prohibits banks from holding most CLOs with bonds in them, meaning the banks have to sell off these types of CLOs, unless the bonds are removed from the CLO portfolios.

However, the amendment bills relating to CLOs could take several years to pass through the various committees of Congress, as well as the house floor, and are potentially subject to presidential veto.

Banks therefore have implemented programs to comply with the Volcker Rule as it currently stands, and not rely on potential reform of the legislation, according to the American Bankers Association.
According to the association’s annual survey of bank compliance officers, published in July 2015, 46.3% of banks have rolled back products and services as a result of Dodd Frank and other “regulatory burdens”.

“Amending legislation can take several sessions [each session is two years] of Congress,” says ABA vice president and chief counsel Tim Keehan.

“Things can get past, but it’s very tricky to predict if they will, and when. There’s so much give and take and so much fluidity in the legislative process.”

Clarification needed
A more immediate issue for banks is the challenge of defining covered funds, as the regulator’s definition is very broad and extends beyond hedge and private equity funds. For example it includes funds investing in local infrastructure projects under the Community Reinvestment Act, which requires banks to make a certain amount of investment in their communities, either through investments or direct loans to relevant organisations. Regulators are currently examining banks investments and processes to ensure Volcker compliance and offer clarification where it is unclear whether a fund is covered or not.

According to Keehan, “A huge process for checking that banks are complying with the conditions of the Volcker Rule is currently underway. According to the law five federal agencies have overlapping jurisdiction and they all have to agree for guidance to be issued.

“The examiners ask on what basis banks have concluded that their funds are not covered funds.

“It may be that funds that are clearly not private equity or hedge funds are nevertheless covered funds, the problem is that they [banks] don’t know. The language in the legislation is vague. That is what we hope the regulators’ examination process will bring out.”

Banks can apply for the further extension for illiquid funds on a fund-by-fund basis but the ABA has, according to Keehan “made a representation” to the Federal Reserve, to extend this on a wider scale.

“We believe we have made a good case to the Federal Reserve for extension for illiquid funds because they could be difficult and expensive to sell. The prices change in anticipation of the illiquid funds coming to market.”

Losses expected
The bulk of CLOs issued since the Volcker rule was finalized are complying with the regulation and can thus be held by banks. Banks have also been able to work with existing CLOs to replace bonds with loans, where possible.

“In the past year, banks have worked hard to get the CLOs in which they are invested to conform to the Volcker Rule,” says Meredith Coffey, Executive Vice President of Research and Analysis at the LSTA.

“However, around the time of the first Volcker deadline in July 2015, we have seen banks selling non-compliant CLO investments that they were still holding. That is likely what has driven the increase in CLO note trading in the last few months.”

According to a report by Deutsche Bank, yields over benchmark rates on AAA rated CLOs issued before the financial crisis climbed to a range of 1.2 percentage points to 1.5 percentage points in June, up from a range of 0.8 of a percentage point to 1.15 percentage points in May this year.

Bank’s losses from forced sales of remaining covered CLOs are estimated to end up around US$3.6bn in total by the US Loan Securitization & Trading Association.

“The regulator has successfully precluded CLOs from investing in bonds” according to Daniel Nathan, Regulation Partner at law firm Morrison & Foerster. “In response, however, many CLOs are increasing investments in second-lien and unsecured loans which carry much the same risks as bonds.”
Dubbed as the big bang of financial services regulation to take place in the EU, the second Markets in Financial Instruments Directive (MiFID) is intended, amongst many other things, to tackle dark trading by extending transparency requirements into the non equity markets.

MiFID II is a sequel to the directive that came into force in November 2007, as part of the European Single Market Programme, to remove barriers to cross-border financial services within Europe and to foster a competitive and level-playing field between European Economic Area trading venues for financial instruments.

MiFID I introduced harmonized transparency requirements for trades in shares taking place on a trading venue. It was always intended to be reviewed after three years, and lessons learned from the 2008 financial crisis informed the review, which began following the G20 Pittsburgh Summit in 2009.

MiFID II therefore became a vehicle for the G20 trading obligations and to remediate some issues created by MiFID I. The resulting hybrid legislation extends the scope of transparency requirements to non-equity investments, such as bonds, commodities and derivatives and is designed to make them trade more like equities.

It aims to address dark trading as well as new risks, such as the growth of high-frequency algorithmic trading, that have developed as technology and financial innovation has progressed.

Technological advances
The directive will become effective from January in 2017 and will fundamentally alter the way that equity, debt, derivatives and commodities are traded, cleared and reported. European regulators want to see trading of these asset classes move on to regulated trading venues, similar to how the equities landscape has been shaped since 2007 when the original MiFID regulations came into being.

Together with a few other key regulations, it will define the future markets for bonds and derivatives trading.

Changes at a glance:
• Introduction of OTFs as a new trading venue
• Standardized and sufficiently liquid derivatives to be traded on eligible platforms
• Additional systems and control requirements for algorithmic trading
• Increased product intervention powers for ESMA and national regulators
• Extension of scope to additional instruments
• Minimum enforcement fines
• More detailed requirements in respect of directors and governance committees
• Diversity requirements for the composition of the management body
• Extension of pre and post trade transparency requirements to non-equity instruments
• New transaction reporting requirements
• Introduction of definition for independent advice
• Possible restrictions in respect of inducements including provision of research
• More detailed requirements in respect of best execution

In summary, MiFID II will curb high-frequency trading, add position limits for commodity derivatives, move more trading to regulated platforms and extend pre and post trade transparency to most, previously OTC, asset classes.

Pre-trade transparency requires that trading venues publish information on the current bid and offer prices and the volume of trading at those prices. Post-trade transparency involves the publication of data on the trades once these are executed.

In addition to post-transparency disclosures, investment firms must also report to regulators complete and accurate details of the trades that they execute. This must be done as quickly as possible and no
later than the working day following that of the execution of the trade.

**Rocky road ahead**
The regulation is wider in scope and more prescriptive than the US’s Dodd-Frank regime. The unintended consequences of the increased transparency rules will be significant. In combination with the increasingly costly capital and funding requirements for market makers, this will pose a great threat to the liquidity and overall functioning of the marketplace.

The downside of excessive transparency is that publication of trade data may have a negative impact on the execution of trades or of related risk-management hedges entered into after execution, thus affecting the price formation and best execution objectives that the transparency requirements are intended to enhance.

This will be particularly the case for trades in less liquid instruments erroneously labelled by ESMA as liquid and for large-sized block trades where the post-trade waivers are insufficient to allow efficient position management by market-makers.

**Major obstacles**
The reforms may also increase the risks of trading numerous fixed income instruments, and lead trading firms to restrict their liquidity provision, move more clients towards an agency model, or leave the markets entirely. Too much transparency also risks constraining financing of the real economy, as only a small proportion of bonds can be successfully traded on an equities-style exchange model.

With MiFID II regulators sought to make the market more transparent. They applied the rationale behind MiFID I to the dark places without an adequate understanding of how the different markets have grown or the differing levels of homogeneity in them.

The problem is that the exchange traded equity markets differ hugely from OTC markets. The exchange based model has evolved more organically for equities, a considerably more homogeneous market than the bond and derivatives markets. Simply taking the principles of the equity markets and applying them to OTC markets will not work without creating major obstacles and stumbling blocks.

A combination of Basel III, CRD 4 and MiFID II creates a perfect storm that will have a tremendous effect on liquidity and on the cost of running a portfolio, which will ultimately be borne by investors.

---

**ROCKY ROAD AHEAD**

**Impact of MiFID II on the Investment Research Market**

**Unbundled Pricing Models Could Transform Investment Research**
- Banks are reported to be devising new pricing models for investment research in view of EU proposals that could prevent research from being paid for using dealing commissions.

**Europe’s New Research Commission Rules May Drive Change Globally**
- Without international convergence global companies could deploy the EU system on a worldwide basis in order to minimize operational strain.
- This may encourage non-EU regulators to adopt the EU approach.

**A La Carte Investment Research May Rise in New Unbundled World**
- The price and underlying value of investment research will be subject to close scrutiny starting in 2017.

**Asset managers may become more selective about what they buy, choosing tailored coverage instead of paying a lump sum for a wider bundle of research.**

**Research Commission Rules Likely to Be Clarified During 2015**
- Final rules on separating research costs from dealing commissions will unfold in 2015.
- At the EU level, the European Commission should adopt its position on EU securities authority ESMA’s proposals in Q3.
- The U.K.’s FCA, and the EU’s other 27 national regulators, will likely start to consult on changes to local regimes in Q4.
- The new rules are scheduled to take effect across the EU on Jan 3, 2017.
Financial regulation began in earnest well before 2008, but the aftermath of the financial crisis saw a rapid acceleration in the introduction of multiple rules and guidelines across the globe, as governments and regulators came out in force, determined to change the way the industry operates.

Among the spate of new laws, a number of key initiatives stand out. In 2007, the EU introduced the Markets in Financial Instruments Directive (MiFID), with the aim of increasing competition and protecting consumers within the investment-services sector. This was closely followed in 2009 by the Solvency II Directive, which targeted European insurance firms, ensuring they must protect themselves from the risk of insolvency.

In the US meanwhile, President Obama signed the 2010 Dodd-Frank Act, which comprehensively overhauled the nation’s financial-services industry – the law was designed to improve “accountability and transparency”, end the notion of “too big to fail” and halt bailouts by the taxpayer.

European Market Infrastructure Regulation (EMIR) in 2012 focused on stabilizing the over-the-counter (OTC) derivative markets, while Basel III, a year later, set its sights on strengthening banks’ capital requirements.
REGULATIONS:
A Timeline Through The Years

Year of enactment | Country affected
--- | ---
2002 | • Sarbanes-Oxley Act
2004 | • Basel II
2005 | • Market Abuse Directive (MAD)
2006 | • Companies Act
2007 | • Markets in Financial Instruments Directive (MiFID II)
 | • Swiss financial market supervision act (finmasa)
2008 | • Emergency Economic Stabilization Act
 | • Money Market Liquidity Facilities
2009 | • Canadian derivatives reporting
 | • Solvency II Directive
2010 | • Alternative Investment Fund Managers Directive (AIFMD)
 | • Dodd–Frank Wall Street Reform and Consumer Protection Act
2012 | • European Market and Infrastructure Regulation (EMIR)
 | • Financial Services Act
 | • French Financial Transaction Tax (FTT)
 | • Short Selling Regulation
2013 | • Financial Services Act
 | • Basel III
 | • Capital Requirements Directive IV
 | • Capital Requirements Directive IV / EU’s Capital Requirements Directive (CRD4)
 | • EU Transparency Directive Review
 | • Financial Services (Banking Reform) Act
 | • Foreign Account Tax Compliance Act (FATCA)
 | • Italian Financial Transaction Tax (FTT)
2014 | • Australian Securities and Investments Commissions (ASIC)
 | • Financial Transaction Tax
 | • Market Abuse Regulation (MAR)
2015 | • Regulation on Energy Market Integrity and Transparency (REMIT)
2016 | • Market Abuse Directive II (MADII)
2017 | • Markets in Financial Investments Regulation (MiFIR)
EMIR’s requirement that all derivatives market players now file speedy and accurate reports has led to the sector adopting some radical new strategies.
The European Market Infrastructure Regulation (EMIR), which emerged in order to tackle the opaque and often complex nature of over-the-counter (OTC) derivatives has been seen as a game-changer in regulating the derivatives market, and post-trade reporting. But what has been the reality, and is it having the desired effect of reigning in what still is a relatively opaque trade?

Having come into force in August 2012, EMIR was another product of the commitments made by the G20 2009 Pittsburgh summit. Many companies thought EMIR should have been purely a banking regulation, as they were not themselves geared up or equipped to deal with the new reporting landscape. Both the fund managers, and brokers or dealers, are required to report the valuations of all derivative trades to an appointed trade repository at the end of each day.

Taking responsibility
Smaller firms lacked the in-house capability to report themselves, and many buy-side firms assumed that their banks would undertake the task on their behalf, and relied on them to do so.

However, all firms are responsible for the accuracy of their reported data. If a buy-side firm delegates the function of reporting to a sell-side firm, they are still ultimately responsible for its accuracy.

The directive has so far thrown up problems that are still in the process of being ironed out. Once the official trade repositories had been officially registered, they quickly experienced a surge in requests following the start date and struggled to deal with the volume.

Improvements needed
With respect to reporting, it was the banks that came up with a solution to report customers' trades, as they already had the infrastructure to do it. They came up with a system of delegated reporting to comply with the regulations, which particularly assisted buy-side firms, few of which have elected to do the reporting themselves.

One of the biggest issues initially was the consistency of the data provided – regulators have since introduced new ‘validation rules’ as guidance, set to come into effect at the end of the year. Reporting is also costly for those tasked with doing it. Large volumes of data is received daily and reconciling trades sent by parties on both sides is proving difficult. More work is needed to define best practice on both sides, but that will take time and require collaboration.

Banks and other organizations, including Bloomberg, have come up with models to assist companies with reporting requirements. For those who want to move away from the delegated-reporting route and take ownership of the report in-house, Bloomberg’s EMIR reporting solution provides customers with an integrated workflow system enabling them to confidently send trades and valuations to trade repositories themselves.
Global regulatory emphasis on data collection, market abuse prevention, and event reconstruction, particularly regarding derivatives trades, have led to increased investment in both internal technology staff and outsourced solutions.

In recent years various jurisdictions – from Dodd Frank in the United States, to the Markets in Financial Instruments Directive (MiFID), European Market Infrastructure Regulation (EMIR) and Alternative Investment Fund Managers Directive (AIFMD) in Europe – have focused on regulation that requires hedge funds to demonstrate they have procedures in place to identify malpractice.

“The emphasis among regulators now is to ask for policy and procedure for a variety of areas,” says Jennifer Wood, head of regulation and sound practices at the UK’s Alternative Investment Management Association.

“You have to have ongoing monitoring to ensure that you catch people before they do X or Y, otherwise you’re not complying.”

She says there has been an increase in hedge funds building and buying in solutions to be able to provide “a huge increase in reporting.”

“Certainly there’s been an increase in compliance staff and an increase in internal tech staff,” she adds. “All this systemic risk reporting is creating the need to increase resources internally and externally.”

**Decision time**

Harald Collet, global head of Bloomberg Vault, which provides financial service regulatory compliance solutions, states that market abuse prevention, conduct surveillance, and trade reconstruction are increasingly becoming hedge funds compliance officer’s concerns.

He says: “We see a strong correlation of requirements within both North America and Europe and Asia now.

“Trade reconstruction and record-keeping cuts across Dodd Frank and MiFID II. A strong focus is on protecting investors and demonstrating best execution, whether firms obtained multiple bids and executed trades appropriately. Globally, regulators have also focused on protecting the integrity of the markets by increasing surveillance of both trades and communications to improve the prevention and detection of insider dealing and benchmark

---

**Tighter compliance regulations are forcing hedge funds to act now by building up internal resources and employing outsourced tech solutions**
Regulations

EU Weighing $17 Trillion Investment Arena Passport: Policy Watch
Rule Summary:
• Global hedge funds, real estate investment trusts, private-equity and venture-capital firms could have easier access to Europe’s $17 trillion asset-management market by 2016.
• The European Commission may give foreign alternative investment managers the equivalent of a passport, allowing them to freely market non-European Economic Area funds inside the 31-member bloc.

Europe Woos Foreign Hedge Funds and Private Equity With Passport
Three options could be available to foreign fund managers if European regulators grant passporting rights
• They could comply with the revised regulation.

Security concern
And AIMA’s Wood warns that even hedge funds using outsourced solutions like Bloomberg Vault have had to increase internal resources alongside third party produces.
“Even if they outsource their tech, they need people who understand how it works,” she says. “If having a chief technology officer wasn’t necessary for them previously, they may need to have one now.
“The flipside of an increasing dependence on tech is that you get exposed to new risks coming from external sources. Cybersecurity, i.e. keeping your data secure, becomes a concern.

Survey: Overseas Alternative Asset Managers May Flock Throughout Europe
Which countries would most likely benefit from the ‘passport’.

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>54.8%</td>
</tr>
<tr>
<td>South America</td>
<td>14.5%</td>
</tr>
<tr>
<td>Asia</td>
<td>21%</td>
</tr>
<tr>
<td>Europe</td>
<td>14.5%</td>
</tr>
<tr>
<td>South Africa</td>
<td>3.2%</td>
</tr>
<tr>
<td>Australia</td>
<td>0%</td>
</tr>
<tr>
<td>Middle East</td>
<td>0%</td>
</tr>
<tr>
<td>Africa</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

Source: Multifonds, The Impact of AIFMD and Convergence Study, March 2015

TECH ACTION A mixed outlook for Hedge Funds

• Use the existing national private-placement regime (NPPR), which requires burdensome arrangements with each country,
• Establish a local branch or subsidiary.

Hedge Funds Beware as EU Procrastinates Over Global Passport
• The EU is taking a country-by-country approach to extending the passport regime to foreign alternative investment funds.
Rising Asian populations and a booming middle class mean that Singapore could soon rival Switzerland as the financial-services sector’s No1 investment center

Changing demographics and global-wealth distribution have for many years been forcing financial-service firms to seek out stable, well-regulated centres across Asia. Singapore, in particular, has been positioning itself as one of the region’s most attractive places to operate wealth-management and banking businesses.

Since it abolished inheritance tax in 2008, the city-state has rivalled the longer-established former UK territory of Hong Kong as a local headquarters for some of the world’s largest financial-services firms.

The Monetary Authority of Singapore (MAS) lists 126 commercial banks in its financial directory, of which 121 are designated “foreign”. Merchant banks and representative offices of banks make up a further 77 companies, and there are 281 registered fund-management companies and 55 holders of a financial advisor’s license.

In 2014, Singapore saw 5% of international private-client market volume, according to Deloitte’s Wealth Management Center Ranking 2015 report, where it was ranked as the 6th largest wealth-management center globally – and 2nd in Asia, after Hong Kong – with net new 2014 assets of US$40bn.

The draw of Asia as a wealth-management centre is shown by the fact that only Singapore and Hong Kong have had positive net new assets since 2008.

Population explosion
“There is an underlying driver and it’s a question of Asian demographics,” says Stephen Mitchell,
Singapore’s growth as a financial-service center has benefitted particularly from Swiss financial institutions

Jupiter’s Mitchell says: “Swiss banks’ secrecy is less of a benefit than it used to be. UBS had terrible problems with helping US citizens avoid tax. On the other hand, there don’t seem to have been any scandals about private banks in Singapore.”

Despite this, Switzerland remains the world’s largest wealth-management centre, with an international market volume of US$2trn in 2014, according to Deloitte, compared to Singapore’s US$0.5trn.

The Swiss State Secretariat for International Financial Matters reported this year that financial services employed 210,000 people in 2014 - 6% of total employment.

“A lot of wealthy people, as well as hedge funds, are still moving to certain Swiss cantons such as Zug, with low tax rates,” adds Mitchell. “Switzerland is popular with a lot of elderly people in particular.”

So while Switzerland remains the current destination of choice for financial-service firms, the long-term appeal of Singapore means that the Asian powerhouse looks set to seriously rival its European counterpart in the years ahead.

head of global equities strategy at Jupiter Asset Management.

“Now the Middle East and Gulf clients are switching towards Singapore, and the growing middle class in India is also looking towards the city-state.

“The countries around it are very populous. The populations, if you draw a circle around Singapore - it’s a very big number.”

MAS’s steps to attract money from wealthy investors include excluding real estate investment trusts from tax on income from foreign properties, and inviting financial-service firms to formally contribute to policy-making through the Financial Services Advisory Panel, established this year.

Swiss difficulties
Singapore’s growth as a financial-service center has benefitted particularly from Swiss financial institutions – including Julius Baer, Lombard Oder and UBP – growing their presence in Asia, in order to benefit from its demographic advantages and following a series of controversies regarding tax avoidance through Swiss banks.
The arrival of Solvency II in 2016 will require the insurance industry to completely transform the way it assesses risk when investing

The insurance sector is the largest investor in Europe, but the rules that have governed it since Solvency I was introduced in the 1970s have developed in a piecemeal fashion with a plethora of regulations and directives, implemented variously by member states. All this is set to change with the arrival of Solvency II. Due to come into effect on 1 January 2016, the legislation will replace the 14 existing EU directives and introduce a risk-based capital framework and harmonized regulatory regime.

Solvency II applies the principles of bank regulation to the insurance industry. It will significantly tighten requirements for how much capital insurance companies will need to hold, impose tough new rules governing how they identify and monitor risk, and set strict disclosure guidelines to increase transparency.

Protecting policy holders
As for other financial sectors, regulators have been eager to try to tighten up regulation since the 2008 financial crisis. In relation to the insurance industry, the aim has been to strengthen policyholder protection in the event of a future financial crisis as well as provide a mechanism that indicates to managers where the risks lie for their company.

To that end, regulators have sought to introduce a consistent method for the valuation of assets and liabilities that is standardized across Europe.

Traditionally insurance companies have focused more on their liabilities and have been keenly aware of the risks to their business, for example those associated with the change in mortality rates and the impact of inflation rates on their expected liabilities and cash-flow.

Solvency II puts more focus on the management of their assets, raising the awareness of insurance companies on the market risk borne through their investments. The legislation is far-reaching and has forced insurers to reassess everything from risk analysis and asset allocation, to products and prices.

In particular they will now have to manage their risk in relation to both assets and liabilities, and put aside some capital for market risk, not only for insurance business risk.

They will also need to adopt a ‘look through’ approach to the funds they have invested in to avoid attracting higher capital charges. That will require greater attention paid to the underlying investments and their associated risks. Appropriate structures for that risk management will need to be put in place.

Insurers will have to take into account capital requirements in their investment decisions
Changing relations

Solvency II may also lead to changes to insurer’s relationships with asset managers. For instance, some big insurance companies may decide to bring their asset management function in-house to increase their control and minimize risk. Or they may reduce the number of asset managers to cut costs. Smaller insurance companies may, on the contrary, rely on asset managers to a greater extent due to the increase in data required by the reporting provisions.

Insurers will also have to take into account the capital requirements introduced by Solvency II in their investment decisions and capital allocation, as they vary according to the asset class. Some may even need to adjust their asset allocation to comply with certain capital requirements set out in the directive, depending on their capitalization and profitability.

The current low interest rate environment is an additional challenge, as insurers try to increase their yields without opting for more risky investments that would attract a higher capital charge.

Insurers may diversify more, in order to take advantage of the capital benefits available for doing so. And while the directive seeks to encourage some types of investments, such as in European venture capital and infrastructure project bonds, there are also concerns that it will discourage them from other types of investment.
THROWING OFF THE SHACKLES

A series of liberalizing reforms reflect China’s desire to boost its economy by attracting overseas investors and to promote the RMB as a key international currency.

The Chinese government’s economic growth strategy is predicated on increasing access to its domestic markets for overseas investors. Essential to this strategy is having its currency, the RMB become an International Monetary Fund-recognized reserve currency. The RMB has previously been rejected by the IMF for this recognition – which BlackRock estimates could increase RMB-denominated assets by US$1trn worldwide – despite being a more widely used trading currency than the euro since 2013, on the grounds it was not “freely usable”.

However, the IMF is in keeping with a range of Chinese policies aiming to increase use of the RMB as a trading currency. Furthermore, as part of its efforts to change the IMF’s mind, China this month devalued the RMB from the artificially high levels at which the currency was kept. The devaluation decision is also an acknowledgement that, despite the Chinese policy of reducing economic reliance on export-focused manufacturing, its exporting industries do need support against the movement of manufacturing business to lower-cost South East Asian countries.

But the People’s Bank of China has claimed it is a move towards less ultimate state control over currency valuations, and therefore in step with the recent trend towards Chinese financial market liberalization, as the government attempts to grow the financial services sector.

FOREIGN BUYERS

25%

THE QUOTA WHICH FOREIGN BUYERS HAVE FILLED TO BUY MAINLAND CHINESE SHARES

6 PERCENT OF THE QUOTA FOR HONG KONG STOCKS

CHINA-HK MUTUAL RECOGNITION OF FUND WILL ALLOW

US$8TRN

THE COUNTRY’S WORTH OF HOUSEHOLD SAVERS TO INVEST IN A DIVERSIFIED RANGE OF GLOBAL ASSETS, VIA ESTABLISHED MUTUAL FUNDS
The historically small international market for Chinese domestic securities is also hindering Chinese economic growth

Clearing up
Among liberalizing reforms, the Shanghai Clearing House began central clearing for RMB-FX swaps and forwards in November last year, following a similar move for RMB interest rate swaps the previous July.

“This move aims to provide a clearing system with better counterparty risk control for currency derivatives transactions, currency forwards and swaps,” says Jian Shi Cortesi, investment manager at GAM.

“The central clearing system will facilitate the growth of the currency derivative markets, as it enhances the ability of the regulators to control system risk, increases the capital efficiency for parties involved in the transactions, and hence makes currency derivative products more attractive to market participants.

“The objective is for the RMB to become an important international currency and people have to have ways of hedging the currency and reducing the risk of these transactions.”

The historically small international market for Chinese domestic securities is also hindering Chinese economic growth, and the 2014-launched Shanghai-Hong Kong Stock Connect “brings China A shares to the global arena and potentially unleashes significant portfolio flows from China to HK”, according to Goldman Sachs.

And – despite analysis of trading volumes on the SH-HK Connect by Bloomberg showing “foreign buyers have filled about 25 percent of the quota to buy mainland shares” – the Shenzhen-Hong Kong Connect could start as soon as March, according to the Hong Kong Exchange.

Overseas access
Meanwhile, index provider MSCI is in talks with the Chinese regulator, with a view to adding China A shares to its indices.

There has been an ongoing discussion between MSCI and the Chinese Securities Regulatory Commission about the limited quota of A shares available to overseas investors, via the Shanghai-Hong Kong Stock Connect, and whether this impedes index funds’ ability to invest in Chinese securities, in line with their objectives.

Asset manager Vanguard is adding mainland Chinese shares to its Emerging Markets Stock Index Fund, it announced earlier this year.

A related investment liberalization planned by China is to allow domestic investors access to funds by overseas asset managers, also through Hong Kong.

China-HK Mutual Recognition of Fund will allow the country’s US$8trn worth of household savers to invest in a diversified range of global assets, via established mutual funds.

Major steps
Lending and deposit taking banks will be able to offer interest rates of their own setting from next year, when the state-mandated ceiling is lifted at the end of 2015.

This follows a series of liberalizations of bank rates since the lending floor and ceiling were removed in 2013. Giving banks more control over the rates at which they conduct business has been implemented alongside proposals for a deposit insurance protection scheme, in which the government underpins savings up to a certain level, rather than implicitly all deposits in what remain ostensibly nationalized banks.

National Certificates of Deposits were also introduced in 2013 to boost the Chinese inter-bank lending repo market. The market for these securities was expanded this year, with investors other than banks able to buy them in sufficiently large volumes, depending on investor type.

This range of liberalizing reforms “are major steps in moving towards full capital account convertibility for the RMB”, says Cortesi: “Chinese leaders have realized that China’s financial market development is seriously lagging its economic development. This is hindering the growth of Chinese companies and is a drag on economic development.

“Capital market participants, brokers, fund companies, investors, all need to adapt to these changes, and be prepared to take advantage of the opportunities they create.”
This is a time of fundamental change in the financial sector, as the industry comes under increasing scrutiny from regulators determined to prevent a repeat of the 2008 financial crisis. Yet despite the onslaught of regulation, periods of great change are often moments of opportunity for those institutions willing to adapt to the new environment and find better ways of working.

Institutions have had to adapt the way they operate in three key areas: banks ensuring that in the future they have adequate capital reserves to survive any future crashes; that they work in a sufficiently transparent manner, so that regulators and those operating in the industry have a clear picture of transactions; and that good governance takes place with regards to board conduct, company structure and bonus policies.

Shape of things to come
Initiatives including the Dodd-Frank Act in the US, MiFID and Solvency II in the EU, and the Basel III Accord have all transformed the global financial environment. They have put a strain on the finances and resources of all those institutions involved, which must now abide by a far more exacting process of accountability.

With market research set to change fundamentally, in terms of the way it is produced and how it is shared, new avenues of opportunity will arise for those willing to analyze data in original and innovative ways. With information now more freely available to the market, the most sophisticated methods of number-crunching will play an increasingly vital role in the success or failure of financial firms.

As this report has demonstrated, banks that can put into action an effective strategic plan which makes the most of their company’s strengths will continue to thrive in this rapidly changing environment. Knowing where to focus resources and turning regulatory challenges into opportunities to be more efficient and provide better services will be the key to future success.

Financial firms that adapt to the ever-changing global market and make best use of new data will reap the dividends
Financial institutions face dramatic changes to the way they conduct their investment operations and structure their businesses.

- The United States and European Union have, in particular, been active in moving to introduce legislation, or strengthen existing legislation, aimed at requiring banks and other financial service providers to reduce risk in their trading and investment practices.

- European banks, for example, have been increasing the volume of their businesses devoted to retail and mortgage-lending activities, as the Basel III legislation disincentivizes investment banking by placing higher capital requirements on trading books.

- Solvency II plays a similar role for insurance companies, and both business types have been investing significantly in teams and tools aimed at assessing the risk in their businesses to ensure compliance.

A firm rule

- In the US, the Dodd Frank Act has placed similar capital adequacy rules on banks for some time, but its incoming Volcker Rule prevents retail banks from holding certain assets deemed to be illiquid or high risk.

- US banks need to have staff and processes in place to explain and justify investment positions to up to five regulators, who assess them for Volcker compliance.

Majority report

- Under the European Mifid II legislation, trading venues must publish a substantial amount more data about trade volumes and pricing, and report much of it to regulators. This requires an increase in resources aimed at such reporting, as well as making it harder for them to trade more opaquely priced assets.

- Meanwhile banks and asset managers face similar reporting challenges in derivative trading because of the European Markets Infrastructure Regulation, with many buying in third-party compliance solutions.

- Some of the most onerous transparency rules govern hedge funds. Similar legislations in both the US and Europe requires them to report every decision-making stage of all trades and positions, with serious cost and resource implications for compliance.
To learn more about what the Bloomberg Professional Service can do for you, contact your regional sales representative or visit: 

bloomberg.com/professional/regulation

BEIJING
+86 10 6649 7500

DUBAI
+971 4 364 1000

FRANKFURT
+49 69 9204 1210

HONG KONG
+852 2977 6000

JOHANNESBURG
+27 11 286 1949

LONDON
+44 20 7330 7500

MOSCOW
+7 495 937 6770

MUMBAI
+91 22 6120 3600

NEW YORK
+1 212 318 2000

SÃO PAULO
+55 11 2395 9000

SINGAPORE
+65 6212 1000

SYDNEY
+61 2 9777 8600

TOKYO
+81 3 3201 8900