REFINITIV EXPERT TALK

UNPACKING THE REGULATORY LANDSCAPE SHAPING FINANCIAL SERVICES IN 2020

A new Refinitiv webinar sees a panel of experts unpack the regulatory trends shaping the financial services industry in 2020, and delves into the impact of COVID-19 on those regulations. The panel also discusses the data management challenges these regulations create and looks at how financial organizations can proactively manage their obligations.

A complex and dynamic regulatory environment

The financial services industry is operating against a backdrop of significant regulatory scrutiny and increasing reporting obligations. From the approaching LIBOR migration to the Securities Financing Transaction Regulation (SFTR), and from the Central Securities Depositories Regulation (CSDR) to MiFID II, banks and financial institutions (FIs) are facing regulatory change at unprecedented levels.

Unsurprisingly, differing levels of maturity relating to implementation are evident across the industry. As is often the case, some banks and FIs are better prepared than others.

The advent of the COVID-19 pandemic has further complicated an already challenging landscape. Many banks and FIs were asked by regulators to provide additional information relating to how the pandemic was affecting their businesses, and such requests inevitably translated into reporting requirements increasing substantially, often on short notice.

On the flip side, the pandemic has also afforded some relief, with a specific example evident within Germany, where the regulator adopted a more generous view regarding trades being conducted out of office. The previous – and strict – requirement was that all trades had to be concluded from the trading floor, but this was relaxed under the extreme circumstances created by the pandemic.

Against this backdrop, our panel of webinar experts discussed some of the notable regulatory initiatives shaping the financial services industry in 2020. Here are some highlights.

Europe: the RRM package

In 2016, the European Commission (EC) proposed a banking reform package aimed at risk reduction and designed to help complete Europe's postcrisis regulatory reforms. This package was agreed on by the European Parliament in April 2019, and implements a range of rules for banks. Known as the Risk Reduction Measures (RRM) package, its express purpose is to render the financial system more resilient and stable.

RRM includes amendments to the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD), as well as the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR)[1].

Michael Cluse, Director, Risk Advisory – Financial Risk at Deloitte, highlights that there are many notable areas within the package, including:

- Pillar 1, which covers counterparty credit risk, and the fundamental review of the trading book (FRTB)
- Pillar 2, which looks at interest rate risk in the banking book (IRRBB), supervisory review and evaluation processes (SREP) and stress testing
- Pillar 3, which covers disclosure
- Additional topics, including, but not limited to the minimum requirement for own funds and eligible liabilities (MREL) requirement, total loss absorbing capacity (TLAC) and ongoing concerns relating to dealing with sovereign risk, an issue which has not progressed in several years

This wide range of changes, considerations and new obligations will span the next few years and will demand a substantial commitment from banks and FIs. Compliance teams are likely to encounter a host of attendant challenges, many relating to data and data management.

Cluse contends that the biggest problem remains counterparty credit risk and stresses that this is essentially a data issue. Changes must be implemented from the front office through to regulatory reporting and this constitutes a significant and complex task for banks and FIs.

Cluse further points out an important and notable shift in regulator focus, highlighting that many regulators are increasingly concentrating on internal assessments within banks and assessing whether these are in line with the risk-taking capacity of the organization in question.

The finalization of Basel III

The finalization of Basel III (often referred to as Basel IV) remains a moving target and has been delayed somewhat by the COVID-19 pandemic.

Some of the essential changes highlighted by our experts include:

The standardized approach for credit risk (CRSA) aims to increase risk sensitivity and reduce dependency on external ratings. New exposure classes as well as recalibrated and more differentiated risk weights, plus modified conversion factors mean that capital requirements under the standardized approach could look quite different in the future.

Cluse highlights that the internal ratings-based approach (IRBA) has a reduced scope, as well as restrictions in the estimation of IRBA parameters. The modified recognition of risk mitigation techniques and the elimination of the scaling factor mean that capital requirements under the IRBA could potentially reduce in the future.

In terms of operational risk, there will be a completely revised framework. In the future, the business indicator will be based on similar data as is the case today, but new mathematics will be introduced. The new standardized approach to operational risk will be based on banks' own loss histories through a loss multiplier approach.

Additionally, the introduction of the output floor means that any bank using internal approaches will be required to calculate the corresponding standardized approach in parallel. There will be limited capital relief from using internal models.

1 deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/Banking/lu-rna-eu-banking-package.pdf

The fundamental review of the trading book (FRTB)

FRTB forms part of the Basel III framework. Global in nature and impact, it constitutes a revised set of prudential standards that specify the means by which banks must calculate market risk capital requirements.

The regulation has a January 2023 implementation deadline and some notable aspects include:

- A revised trading book vs. banking book boundary
- A revised standardized approach to support consistency and a comparison of capital requirements across banks, which is based on a more risk-sensitive framework
- A revised internal models approach. This includes a more granular standard for the approval process and model validation at the trading desk level

The data management challenges presented by FRTB are many. Banks and FIs will need to source, process, normalize and interface with real price observations to determine which risk factors pass risk factor eligibility test (RFET) compliance. They will also need to source additional historic time series market data back to 2007, as well as fund and index constituents and weights information for look-through requirements, with a further requirement being the classification of buckets for the standardized approach.

Jacob Rank-Broadley, Director, Regulatory & Market Structure Propositions at Refinitiv, points out that there is a crucial need to ensure good-quality data and contends that achieving this at scale may appear straightforward on paper, but presents a real hurdle in reality. Given the vast quantities of data required, there are significant operational implications for firms.

LIBOR migration

In a live audience poll conducted during the webinar, 44% of the audience selected LIBOR migration as their firm's priority for next 12 months.

The production of LIBOR, the interest rate benchmark that is widely adopted in financial markets and underpins trillions of USD in financial instruments and derivatives, will no longer be guaranteed by the FCA beyond the end of 2021.

Alternatives to LIBOR include overnight risk-free rates such as SONIA, SOFR and €STR that are administered by central banks; and term reference rates such as TSRR that will be administered by private benchmark administrators.

Rank-Broadley highlights the enormity of the impact of LIBOR migration by pointing out that LIBOR represents approximately three and a half times the world's GDP in terms of contract exposure. With a deadline of just a year and a half away, LIBOR migration is an enormous challenge for banks and FIs.

David Bull, Director OTC Content Management at Refinitiv, outlines that the starting point for firms is to fully understand how they will be impacted, before addressing a range of data management challenges, including:

- Sourcing and licensing new benchmarks such as SONIA, compound SONIA and Term SONIA Reference Rate
- Sourcing new market data in new instruments (for example, listed derivatives, OTC derivatives, bonds) that reference LIBOR alternatives
- Identifying existing instruments that reference LIBOR and understanding their fallback language
- Generating new analytics. Many recommended alternative rates are overnight rates, whereas LIBOR is forward-looking. Firms must therefore ensure that they have the right analytics, calculators and reference data fields within their products in order to allow correct calculations using a backward-looking rate

Many firms have already started to map out their response to the planned cessation of LIBOR, and once again, levels of readiness vary enormously.

The consequences of Brexit

Finally, our webinar panelists discussed the impact of Brexit, a topic selected by 22% of the webinar audience as their highest priority from an implementation perspective over the next 12 months.

MiFID, the Markets in Financial Instruments Directive, is a regulatory framework set out by the European Union (EU) to regulate its financial markets. MiFID's express aims include increased transparency, a shift in trading toward more structured marketplaces, improved best execution and the promotion of more orderly trading behavior within markets.

As the post-Brexit world unfolds, MiFID will be applied in UK law resulting in the formation of a parallel regime with reference data no longer provided by EU authority, ESMA, but rather by the FCA. Bull contends that the expectation is that initially, ESMA and FCA values will be the same or similar, but could then start to diverge.

The reference data provided by ESMA drives the reporting obligations rules for trade and transaction reporting, so firms will need to ensure that new reference data FCA equivalent fields are in place.

Advice for banks and FIs responding to regulatory change

The scale and range of the regulatory challenges facing banks and FIs in 2020 and in the coming few years should not be underestimated. Specifically, many of the challenges outlined by our experts relate to data and data management.

The importance of access to reliable, trusted data and leading-edge data solutions cannot be overemphasized in an environment where the ability to respond to changing regulatory requirements quickly, accurately and efficiently has become critical.

Those firms that adopt a proactive approach, invest in the right resources and engage with the right partners to meet unfolding challenges are likely to experience the least disruption to their operations and are most likely to remain ahead of a dynamic regulatory curve.

Access the full webinar here.

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