THE JAPANESE REGULATORY ENVIRONMENT 2017

AN INDUSTRY REPORT

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Upon a backdrop of global regulatory developments, misconduct and geopolitical instability, the Japanese regulatory environment continues to shift and increase the compliance burden on financial institutions. The expectation to abide by regulator guidelines, promote a culture of compliance and avoid enforcement actions at a time when compliance budgets are feeling the strain, means organizations are having to explore new strategies and technologies to drive efficiency and remain competitive.

The Japanese Regulatory Summit, running on 7th March in Tokyo, will discuss these issues and more. This report is comprised of Thomson Reuters Regulatory Intelligence articles and covers the themes and topics that will be discussed in more detail at the event.

For more details and to register for the event visit:
http://financial-risk-solutions.thomsonreuters.info/japanregsummit17

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JAPAN REGULATOR SIGNALS NEW SUPERVISORY APPROACH TO BOOST GROWTH

Trond Vagen, North Asia Editor, Thomson Reuters Regulatory Intelligence

Global banking regulation does not look enough to the future and a more holistic perspective is needed to ensure a good mix between financial stability and economic growth, Japan's top financial regulator said.

Nobuchika Mori, the commissioner of the Financial Services Agency (FSA), said banking supervision needed to change, and that the Japanese regulator was building a new "toolbox" to ensure it was able to ensure forward-looking risk management for the banking sector.

As part of its new "toolbox", the FSA has introduced a set of benchmark indicators showing how banks implement their policy to meet customers' needs, and also plans to enhance disclosure on the quality of the financial services provided, he said. In addition, the regulator would look to develop codes and principles instead of minimum standards.

"We will supplement Basel Pillar One regulations with dynamic, forward-looking supervision tailored to each bank and the changing environment," he said, noting that static regulations based on past balance-sheet numbers needed to be supplemented by dynamic supervision tailored to future prospects of each specific bank.

Speaking at a recent conference, Mori said that setting minimum standards for policing risk-taking would not be enough to meet the challenges of the day.

"Regulators need to have effective dialogue with bankers about how they can create value shared with their customers and play useful roles in society," he said. "In addition to a standard check on the resilience to the recurrence of past shocks, bankers and regulators should explore the implications of emerging risks and structural changes."

The tools that have been used so far to address the fallout from the financial crisis were not suitable for spurring future economic growth, he said.

"The conventional combination of regulation, inspection and enforcement action may not be conductive to market participants' own initiative and innovation, which is the foremost critical success factor in meeting the new challenges," he said. "We must supplement our past approach with a new toolbox needed for dialogue with banks on questions with no single answer, on best practices beyond the minimum, on business models, profitability, and forward-looking risk management."

Mori said regulators should aim to achieve balance between financial stability and effective financial intermediation, between consumer protection and consumer benefit and between market integrity and market vigor.

"The global regulatory community should pay more attention to the substance, the future and the holistic view," he said. "Our efforts towards financial stability should be designed so that the resultant stable financial system could contribute to sustainable economic growth, which is our ultimate goal."

"We also need effective financial intermediation to attain sustainable economic growth: what we want is not the stability of a graveyard," he added.

This is an edited version of an article originally published on the Thomson Reuters Regulatory Intelligence platform.

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VARIATION MARGIN RULES FOR NON-CENTRALLY CLEARED DERIVATIVES PRESENT SELL-SIDE CHALLENGES

Patricia Lee, South-East Asia Editor, Thomson Reuters Regulatory Intelligence

The new requirement to post variation margin for non-centrally cleared derivatives is expected to present significant challenges to financial institutions, particularly the sell side, which may lack the right collateral, liquidity and operational capability.

Variation margin is posted daily to cover mark-to-market positions in derivatives price movements. The mandatory requirement for market participants to post variation margin has become a market-wide issue largely because it applies to all financial counterparties including asset managers, pension funds, insurance companies and hedge funds. Corporates which trade significant volumes of derivatives with banks will also be caught by the variation margin requirements.

MASSIVE TASK

With the March 1, 2017 variation margin rule implementation deadline looming, this has given rise to concerns about whether financial institutions are ready in terms of their legal documentation, operational infrastructures, their ability to meet the strict requirements on the type of collateral that can be posted and the required timing for settlement.

"The scale of the task is massive, and firms [financial institutions] need to take action now in order to stand a chance of being ready in time," the International Swaps and Derivatives Association said in a commentary posted on its website on November 3.

One of the immediate impacts of the new margin requirement for non-centrally cleared derivatives is on credit support annexes which would require market participants to amend existing ones or negotiate new ones if they did not exist previously, said Tasos Zavitsanakis, consulting director, advisory services at PwC in Hong Kong.

Credit support annexes describe the type and frequency of collateral which counterparties would need to exchange to protect the mark-to-market positions in derivatives movements. It also requires collateral to be settled on a T+1 basis.

SELL SIDE

If market participants are unable to provide collateral on a T+1 basis because they do not have either the liquidity or the operational capability, this would make them effectively non-compliant under the U.S. Commodity Futures Trading Commission (CFTC) rules, Zavitsanakis said. The European margin rules are still being finalised, while some Asian jurisdictions have finalised their rules, all of which are expected to be implemented by end of this year.

Zavitsanakis said the industry is less concerned about banks not meeting the margin requirements, but rather whether their clients, mainly the sell side such as asset managers, fund managers and insurance companies, would be compliant. The concerns lie in whether the sell side has the right collateral, liquidity and operational capability.

"If the sell side needs to create liquidity, they can ask banks to do asset transformation to create the liquidity but there will be cost involved. The sell side may not have the operational infrastructures as well," he said.

T+1

To ensure that they comply with the new margin rules, banks need to know whether their clients are able to trade on a T+1 basis, and they will only transact with counterparties with such capability, Zavitsanakis said.

"The issue [for banks] then becomes: how can I be compliant? The only way to be compliant is to use U.S. government bonds, UK government bonds, euro bonds and Canadian government bonds, all of which are able to settle on a T+1 basis. Most other bonds settle on a T+2 or T+3 basis," he said.

The different requirements under the margin rules in different jurisdictions will affect market participants in different ways, said Terry Yang, consultant at Clifford Chance in Hong Kong. Depending on the rules in which country market participants will be subjected, this will in turn determine the kind of collateral they can use to post as variation margin, Yang said.

"If a bank is subject to the T+1 requirement under the CFTC rules and it is trading with a counterparty that is not able to satisfy the T+1 requirement, then it will not be able to trade with such a counterparty," he said.

EUROPEAN AND ASIAN MARGIN RULES

The European margin rules for non-centrally cleared derivatives, which are in the process of being finalised, have a slightly different requirement. The market generally interprets the European rules as requiring instructions for delivery of collateral to be given by T+1, according to Yang.

Asian rules, which vary among jurisdictions, are generally less strict, he said. The Australian regulator, for instance, only requires collateral to be delivered promptly without setting a cut-off time. Hong Kong regulator has set a more generous timeframe for collateral to be exchanged compared to the U.S. and European regulators; it has also set T+3 as the maximum amount of time allowed for collateral to be posted.

IMPLICATIONS GO BEYOND LEGAL

ISDA pointed out that revising and setting up new documentation is a necessary step in the run-up to the margin rule implementation. It has published a variety of revised credit support documents under various legal regimes. The challenge, it said, is how to make those changes without having to negotiate bilaterally with every single counterparty.

Zavitsanakis said legal documentation would need to be dealt with to ensure compliance with the new margin rules, and would require negotiations among the counterparties.

"If the old and new agreements are very different, there may be terms that one counterparty does not want to give up, but banks will just want to simplify the agreement. It would need some kind of negotiation," he said.

The new requirements to post variation margin go beyond legal implications, Yang said. Financial institutions would have to comply with a very strict timeframe; operational infrastructures that are unable to do T+1 settlements would need to be changed; and treasury would need to source for liquidity, he said.

"The variation margin requirement affects different aspects of a non-cleared derivative trade," he said.

The valuation of position is another aspect of non-centrally cleared derivatives which financial institutions and their counterparties would need to agree upon, said Tom Jenkins, partner, financial services at KPMG China.

"As part of the new regulations, market participants are required to ensure that they agree with the valuation methodology and they need to have a dispute resolution mechanism to resolve any disagreement on the valuation," he said.

Given the impending deadline, it would be challenging for market participants to put in place all the necessary arrangements by March 1, 2017, including sorting out the legal documents, making changes to their operational systems, and ensuring there is sufficient liquidity for the collateral, Yang said.

Market participants may end up focusing their efforts on a few key counterparties initially to meet the March 1, 2017 implementation date and then work with other counterparties to remediate outstanding issues relating to the implementation of the margin requirements.

"It is difficult to see how regulators would be willing to push back the March 1, 2017 deadline," he said.

This is an edited version of an article originally published on the Thomson Reuters Regulatory Intelligence platform.

NEW ACCOUNTING STANDARD LIKELY TO REDUCE BANKS' CAPITAL RATIO, ABILITY TO LEND

Patricia Lee, South-East Asia Editor, Thomson Reuters Regulatory Intelligence

The introduction of International Financial Reporting Standard 9 (IFRS9), which requires banks to make credit loss provisioning, is expected to reduce banks' capital ratios significantly, as well as their capacity to lend, consultants said.

Concerns have been raised in the past about making provisioning too late under the existing accounting standard, International Accounting Standard 39. Under IAS 39, banks can only make provisions when a loss occurs. The new expected credit loss (ECL) model under IFRS9, however, is more forward-looking and requires banks to make provisions for expected losses for any loans they make to cover losses that have already been incurred and those expected in the future.

IFRS9 WILL REDUCE BANKS' CAPITAL AND ABILITY TO LEND

The introduction of IFRS9 will increase the amount of provisions, and regulators are concerned the provisions will in turn reduce banks' capital and their ability to lend, thereby affecting public confidence, said Simon Topping, head of regulatory practice at KPMG China.

"IFRS9 could affect banks' ability to lend because of the link between the amount of capital banks have and the amount they can lend," he said.

The biggest uncertainty lies in the amount of provisions which banks must provide, which will vary from country to country, said Keith Pogson, senior partner, Asia Pacific financial services at EY in Hong Kong.

"The finite increase in the amount of provisions could be 30 percent to 40 percent between the incurred loss model and the ECL model," he said.

The Basel Committee on Banking Supervision (BCBS) has examined this in two recent consultation papers: one looks at how the capital aspect of the provision should be managed, while the other focuses on how the new accounting standard IFRS9 should be gradually phased in over a period of three to five years. BCBS has proposed to introduce IFRS9 on January 1, 2018.

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IFRS9 WILL REDUCE TIER 1 CAPITAL

More importantly, BCBS and the industry are concerned about how IFRS9 will affect Tier 1 capital, a focus for most banks under Basel III. Topping said total capital would not be affected too much by IFRS9 but Tier 1 capital would be.

"Under Basel III, the effort was to increase Tier 1 capital, but introducing IFRS9 will reduce Tier 1 capital. Bringing in IFRS9 will potentially increase quite a lot of provisioning because it is based on expected loss which is deducted from Tier 1 capital, and as a result, Tier 1 capital will go down," he said.

The complication does not stop there, however. While provisioning is deducted from Tier 1 capital, it is added back to Tier 2 capital, according to Topping. Capital is intended to cover any future losses in the business, whereas provisioning is an amount earmarked to support future credit loss, he said.

"When part of the reserve is earmarked to support any specific risk it is counted as Tier 2 rather than Tier 1 capital. Because that amount is set aside, any amount of capital set aside for a specific purpose is no longer counted as Tier 1 capital, which is a higher quality capital," he said.

PROVISIONING WHICH CAN BE ADDED TO CAPITAL IS LIMITED

The issue is further complicated by the fact the amount of provisioning which can be added to Tier 2 capital is limited. Banks which use the standardised approach to credit risk are only allowed to add provisioning of up to 1.25 percent of their risk-weighted assets to Tier 2 capital. Total capital would not change because the percentage is limited to 1.25 percent, Topping said.

"Up until the position is reached, all the provisioning can be added to Tier 2 which will go up, and the total capital will be the same. But that will not happen if the provisioning exceeds 1.25 percent. Not all the reduction in Tier 1 will be able to get added back to Tier 2 and so the overall capital will be affected," he said.

Banks using the internal risk-based model approach to credit risk face similar limitations; they are allowed to add provisioning of up to 0.6 percent of risk-weighted assets.

"The technical issue here is that not only will Tier 1 capital fall, total capital will also fall because of the cap at 1.25 percent [for banks using standardised approach] and 0.6 percent [for banks using IRB approach]," Topping said.

Another complication is the concept of provisions. Under IAS39, there are two types of provisions: general and specific. As there is no such distinction under IFRS9, it is unclear at this stage whether all the provisions under Tier 1 can be added back into Tier 2 capital. Banks using the internal risk-based approach also made no distinction between general and specific provisions.

THREE APPROACHES TO PHASE IN IFRS9

Given the potential complications and concerns about the impact on banks' ability to lend, BCBS is therefore considering the introduction of IFRS9 through a phased approach to spread the reduction in Tier 1 capital over several years, Topping said.

Banks have, however, questioned the need for more capital when it is the accounting methodology that has changed. BCBS has therefore suggested three approaches to phasing in the new rules over a period of three to five years.

The key regulatory question, Pogson said, lies in how to smooth in the differences arising from the change in methodology over say a three to five-year horizon, which is then up to the individual countries to decide. The three approaches proposed by BCBS are somewhat similar, he said.

The first approach, known as the straight line approach, suggests that banks take a certain finite number for the provisions and spread them out over a period of three to five years. The second approach provides provisioning as a percentage based on risk-weighted assets.

"In the second approach, say your provision goes from 1 percent to 1.4 percent of risk-weighted assets and so you are going to smooth in on a percentage basis rather than looking at finite amount of provisions. You look at the provision against the book. The change in percentage will stay the same over the period but the underlying book may change. The second approach is more dynamic and more complicated," Pogson said.

The third approach provides a more technical answer, according to Pogson. Under IFRS9, there is a three-stage model relating to non-performing loans. The first stage is when a loan is written and there is a small expectation on credit loss, and the second stage is when something has changed for the worse with the loan.

"The first two stages are really considered as the calculation of the expected loss. The third stage is when the loan becomes non-performing, which effectively constitutes an incurred loss. Under the third approach, you assess the first two stages and you work out the difference and spread it out over the three to five-year period," he said.

CHALLENGES TO NATIONAL REGULATORS

The challenge is most national regulators are still trying to figure out the consequences IFRS9 will bring, which, Pogson said, would be a difficult decision-making process. The good news is there is finally a rule that makes sense, he said.

Asian regulators have yet to show any major concern about the imminent introduction of IFRS9, largely because the capital impact of the new accounting standard on banks in major financial markets such as Australia, Hong Kong, Japan and Singapore is not expected to be huge, Pogson said. But the capital impact of IFRS9 on banks in emerging markets such as China and India may be larger.

"That's because generally the level of portfolio credit quality is relatively strong and hence provisions are quite low at banks in developed Asian markets at this point in time. For instance, the mortgage portfolio in Hong Kong is generally in good shape and there is relatively low loan loss, and so changing the accounting methodology from one to another does not have a huge capital impact," he said.

Investors and analysts will find it challenging to ascertain the capital strength banks have when IFRS9 takes effect, Topping said.

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AS MIFID II LOOMS, SELL-SIDE AND BUY-SIDE TAKE MORE COLLABORATIVE APPROACH TO BEST EXECUTION

Peter Elstob, Senior Editor, Securities and Markets, UK & Europe, Thomson Reuters Regulatory Intelligence

Asset managers are making it their business to understand much better their brokers' cash equity trading strategies, including algorithmic strategies and smart order routing (SOR), as execution becomes more automated and 'scientific'.

This trend is being underpinned by tougher best execution rules in the new Markets in Financial Instruments Directive (MiFID II) but another influence, according to Natan Tiefenbrun, managing director, European execution services, Bank of America Merrill Lynch (BAML), is a more collaborative and trustful relationship that has recently developed between the buy-side and sell-side in the pursuit of best execution.

MiFID II, which comes into operation at the beginning of 2018, holds market participants to a higher best execution standard than MiFID I. Where the original directive required firms to take "all reasonable steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order", MiFID II will require them to take all *sufficient* steps.

"SUFFICIENT" STEPS

In guidance on MiFID II that it updated in October this year, the European Securities and Markets Authority (ESMA) confirmed that "sufficient" steps set a higher compliance bar than "reasonable" steps.

The directive also requires execution venues to publish execution-quality data, and requires brokers to make public annually, for each class of financial instruments they have traded, the top five execution venues in volume terms, where they executed client orders in the preceding year, and information on the quality of execution obtained.

In its October guidance, ESMA said: "When designing their execution policies and establishing their execution arrangements, firms will have to ensure that the intended outcomes can be successfully achieved on an on-going basis ... This will require firms to monitor not only the execution quality obtained but also the quality and appropriateness of their execution arrangements and policies on an ex-ante and ex-post basis to identify circumstances under which changes may be appropriate."

An example of ex-post best-execution monitoring might be to check if the firm had correctly applied its execution policy, and that when using smart orders routers (SORs) or other execution methods had effectively passed client instructions and preferences along the entire execution chain.

"Firms' processes might involve some combination of front office and compliance monitoring and could use systems that rely on random sampling or exception reporting. There should be channels in place to ensure that the results of ongoing execution monitoring are escalated to senior management and/or relevant committees, and fed back into execution policies and arrangements to drive improvements in the firm's processes," the guidance said.

The regulatory agency concluded: "This overarching requirement should not be interpreted to mean that a firm must obtain the best possible results for its clients on every single occasion. Rather, firms will need to verify on an on-going basis that their execution arrangements work well throughout the different stages of the order execution process. ESMA expects firms to take all appropriate remedial actions if any deficiencies are detected so that they can properly demonstrate that they have taken 'all sufficient steps' to achieve the best possible results for their clients."

ACCUSATION OF CONFLICTS OF INTEREST

BAML's Tiefenbrun told ICI Global's global capital markets conference in London that as the cash equity market's structure, particularly in the U.S., became more complicated over the last five to six years, and broker-dealers' margins were eroded, a number of sell-side firms found themselves open to accusations of conflicts of interest.

"Essentially, their order handling policies seemed more about preserving their own margin than getting the best outcome for their customers," he said, and this led to a re-think of the kind of information the sell-side needed to share with the asset managers that are its customers, including details of sell-side firms' governance.

"People want to know how we're running our business, how we're making decisions about what's the right thing to do. So they want to know who's in the room, how are the decisions taken, and making sure that they're not at the mercy of one lone wolf employee who can decide to turn up a knob and somehow line their own pockets," Tiefenbrun said.

Asset managers also wanted information enabling them to verify what brokers told them they did, for example in their choice of venues, against the data on the trades they had actually executed on their behalf.

"As buy-side firms have got more into that data, and a better appreciation for it, they're now using it to partner with their brokers, and saying: I'm looking at what you're doing; can we discuss this? I wonder if this approach or that approach might actually enhance the outcome," he said.

"I think initially, it was quite confrontational, and perhaps rightly so, because there had been a breach of trust, particularly in the U.S. markets. [But] it's moved now, I think very constructively, beyond that breach of trust to one where the additional information is actually strengthening the partnership, and improving the ultimate outcomes for buy-side clients."

REUTERS/ Stefan Wermuth

LESSONS FROM 'FLASH BOYS'

Tiefenbrun pointed out that in addition to quantitative data, there was also a lot of qualitative information that needed to be collected and analyzed. He observed that in the wake of Michael Lewis's 2015 book 'Flash Boys' alleging widespread equity market abuse in the U.S., buy-side firms began asking their brokers about their execution processes.

"A lot of buy-side firms just didn't know exactly which questions to ask, or how to tailor their questions appropriately to the European environment versus the U.S. one," he said.

The Europe-based sell-side and buy-side trade bodies had therefore jointly devised a standardized questionnaire on trade execution for the whole industry to use, which had helped both sides to reach a better relationship. It helped buy-side firms avoid being fobbed off with incomplete or ambiguous answers from sell-side firms, but it also helped the sell-side to have standardized responses to common queries, obviating the need to get each reply signed off by the firm's legal department.

"And then of course the benefit to the buy-side of receiving standardized responses from all the sell-side firms, and being able to line them up," Tiefenbrun said.

"That raised the level of the dialogue between the buy-side and sell-side, so that when it then turned to [quantitative] data questions, you had an intellectual framework in which to understand that routing behaviour ... when you get data on what we're doing you have some context on what [the sell-side is] trying to achieve."

Neil Smith, senior equity dealer, European equity dealing, at State Street Global Advisors, said that in an electronic world, asset managers need to understand why different algorithmic programs, and different SORs, were doing different things, and how and why different brokers were executing on different venues.

"Without understanding ... what's going on under the hood it's very hard to build a picture," Smith told the conference.

State Street Global Advisors recently began a project to improve its understanding of the execution process, including the effect on overall execution quality of using one broker rather than another, and issues such as the knock-on effects of excessive order resting on a particular venue versus another.

"That's been incredibly useful, and will continue to be very useful going forward ... to really understand why things are different, compare them to different brokers, to different strategies, to different SORs, and make use of that data to really influence the way we trade for our clients; the endgame of really trying to tighten our processes, improve our execution, and our understanding of why we're trading in a certain way," Smith said.

BUILDING A PICTURE

Depending on what types of trading strategies asset managers were using — for example, what extent they were interacting with dark versus lit liquidity — they could build up a picture, over time, of what brokers best suited them.

"And [then you can] pick out the outliers. Why is one broker, algorithm, SOR, doing something completely different to another? Who's right, and what suits us best? Those of the sorts of questions we've been asking," Smith said.

MiFID II will also expand the number of equities trading venues, including an extension of the systematic internaliser (SI) regime, which never really took off in its original MiFID iteration.

"It's like ground zero, we're starting from scratch, we've got no historical data to rely on," said Simon Steward, head of European equity trading, at global asset manager The Capital Group.

ESMA is not publishing the list of new SIs until next August, but Steward said he was hearing there could be upwards of 30-40.

"It's going to be really interesting... towards the last six months of 2017, there's going to have to be a lot of discussion between buy- and sell-side in terms of what we really think the landscape's going to look like," he told the conference.

Tiefenbrun said the critical thing for the sell-side was to determine as quickly as possible which new venues and crossing services would both reach liquidity critical mass and provide favourable customer outcomes. He thought the MiFID II-compliant European equities period auction book for 'large-in-size' trades that Bats has already made live seemed "a very sensible idea", but he cautioned that it had not yet achieved critical mass, and he said there were "some real concerns" about its metrics as a venue, although there was no reason to think the model was fundamentally flawed.

Firms therefore need to do plenty of work to understand each new venue's performance metrics as MiFID II comes into operation, and to choose which metrics to rely on to determine whether a particular venue is serving a useful purpose.

"Also, how differentiated is the liquidity? If it's unique and I can't find that liquidity somewhere else, then even that high cost might be attractive. So it's about getting all those metrics in place, and getting the process in place so that you have the organizational discipline to be reviewing and adjusting that data as efficiently as you can," Tiefenbrun said.

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2017 GLOBAL RISK OUTLOOK - WILL THE TRUMP PRESIDENCY BRING AN INFLATION OR DEFLATION?

Tsuyoshi Oyama, Head of Center for Risk Management Strategy, Deloitte Touche Tohmatsu LLC

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For risk management professionals, 2016 was truly a year full of upheaval. No matter how much fuss the media made in advance, we may have become so accustomed to settling on the world of pre-established harmonies (which the media itself predicts) that we have not built up "immunity" to a series of consequences that completely contradict the foreseen scenarios. The unexpected consequences, needless to say, refer to acceptance of Brexit at the U.K. national referendum last June as well as the election of the Republican candidate Mr. Trump at the U.S. presidential election in November. Further, the "Trump market-rally" with sored stock prices, high interest rates and strong dollars that appeared after his election, and the rise in the post-referendum British economy greatly defied the pessimistic predictions.

THREE NEW TRENDS THAT EMERGED IN 2016

#1. "Globalization" to "Fragmentation"

Now, what would the global economy look like in 2017? The key to read into this lies in the unanticipated events taken place in 2016. The events in the U.S. and the U.K., particularly in the former, have a potential to largely alter three trends that have dominated the world economy thus far.

The three trends include "globalization," "ultra-loose monetary policy," and "strengthening regulations." These are about to be replaced by three new waves, namely "fragmentation," "fiscal stimulus," and "deregulation."

Globalization evidently signifies liberalization and vitalization of cross-border flows of goods, services, people and capital, and furthermore, standardization of financial regulations and such beyond nations' borders. This tide of globalization, after the 2000s, brought rapid growth of emerging economies including China, while enhancing interdependence of the worldwide economy, including advanced economies, through expansion and sophistication of supply chain. However, this trend simultaneously caused a downfall of the manufacturing industry and its working-class in the U.S. and others, which then led to the "unexpected" birth of President Trump.

Globalization is exhaustive utilization of "comparative advantage," and in this sense, it has drastically increased welfare not only in emerging economies, but also in overall advanced economies such as the U.S. It is another issue, however, whether its distribution is considered "fair" by the American citizens for instance. Indeed as a result of globalization, the U.S.-based multinational companies have grown their profits, augmenting the income of business owners and the wealthy. Meanwhile the American working-class are exposed to the competition against those in emerging economies, with their income plateauing at best, or declining in many cases, or their job being just lost. Surely it is possible for them to make a career change to find another IT related opportunity on the West Coast, but if this field is dominated by bright Indian and Chinese immigrants, the white Americans from the Rust Belt would find themselves at a dead end.

In the midst of these situations arose the anti-globalization movement, and anti- immigration and trade sentiments formed among the white middle-class Americans from the Midwest and those outside of city of London in the U.K. In other words, this would be a "modern-day Luddite movement." These voices gave birth to the new regimes of President Trump and Prime Minister May that promote policies to restrict immigration, in addition to shifting to protectionism in the U.S. as well as independence from the EU system in the U.K. These policies of the new American and British governments sweepingly change the direction from "globalization" to "fragmentation," aiming for isolation and independence in aspects of flows of people and goods over borders, and rule-making processes.

In fact, this type of movement does not originate solely in political incidents in these two countries. In financial regulation in particular, the "Basel Process," led by the Basel Committee on Banking Supervision to formulate international financial regulation, is on the verge of collapse; the Basel III agreement is postponed despite its plan to be reached by early this year. As discussed in a later section, this can be understood as a reaction to extreme cross-border standardization of regulations, in the same manner as the reaction to excessively tightened regulation after the financial crisis.

#2. "Ultra-loose monetary policy" to "Fiscal stimulus"

The second tide that has ruled the global economy is the "ultra-loose monetary policy." It is still fresh in our memory that many of the advanced economies faced the danger of deflation in the course of long-term saving glut and lowering productivity, particularly after the global financial crisis during 2008 to 2010. The central banks of these countries actively took on "ultra" monetary easing policy as a countermeasure. "Ultra" means to go beyond ordinary monetary easing measures, and specifically refers to "quantitative easing" which forcefully expands the "quantity" of monetary base within the limitation of zero interest rates, and further "negative interest rates" which break the conventional idea of zero bound. Till date, European and Japanese central banks employ both measures while the Federal Reserve Bank still maintains its swollen balance sheet as a result of the past quantitative easing.

Although this type of policies are said to have provided certain stimulating effect on the macroeconomy (especially through currency devaluation and a rise in asset prices), the hike in asset value notably incurred a side effect to further widen the income gap between the affluent and the low- and mid-income households. Then the middle class' repellence against the wealthy, and the financial industry which directly receives the benefits from rising asset prices, serves as a significant factor in the "rebellion" in the U.S. and the U.K. In contrast, the new American and British governments are setting forth the positive adoption of fiscal package such as expansion in infrastructure investment. While mitigating the excessive dependence on monetary policies, this also leads to direct grant of benefits to the working class through public investments and improved investment environment with infrastructure development, which softens the dissatisfaction of the bourgeoisie, the middle-working class.

#3. "Strengthening regulations" to "Deregulation"

Lastly, the third tide that has dominated the global economy is the "strengthening regulations." A representative example would be tightening of financial regulations after the global financial crisis, but environmental regulations have also been enhanced due to concerns over the global warming for instance. Although such enforcement of regulations is led by the supervisory authorities or governmental agencies, it is also strongly supported by the general public fed up with the greed of major financial institutions in the case of financial regulations, and by groups concerned for the environment for future generations in the case of environmental regulations.

The new American and British governments are drastically changing this trend of greater regulatory controls. For example, while the U.S. Treasury Secretary candidate, Steven Mnuchin claims to "preserve the Volcker Rule," the seats for SEC (Securities and Exchange Commission) Chairman and CFTC (Commodity Futures Trading Commission) Chairman are expected to be assumed by those close to the financial industry, or supporters of deregulation. The new board of governor of the FRB, who will also serve as the Vice Chairman of bank supervision and will greatly influence the prudential regulations, is yet to be appointed, but the recent personnel assignment makes us to expect a similar appointment in favor of deregulation. Furthermore, for the environmental regulation, President Trump has indicated a principal change in direction by nominating Mr. Pruitt, who has been against stricter regulation, as the EPA Administrator while immediately approving the plan for Keystone pipelines which the Obama administration was reluctant to approve due to environmental concerns. Also in the U.K., for the financial industry such as the City of London that will lose the privilege from the single-market access passport system upon Brexit, complete transition might be possible from the traditional route of strict regulation to bold deregulation.

It is questionable whether these moves speak for the white middle-class who voted for the new governments in the U.S. and the U.K. Rather, it is reasonable to interpret this shift in trend as representation of the voice of industries that have accumulated discontent. This also implies the potential risk to evoke criticism from the government supporters who feel bitter about the financial and energy industries.

THE GLOBAL ECONOMY IN THE LIGHT OF NEW TRENDS

Three new tides mentioned in this article still remain only within the U.S. and the U.K., and it is uncertain if they will become the new trends worldwide. However, considering the fact that the past three tides were promoted by these two states, and their strong presence in international regulation making as well as the overwhelming economic influence of the U.S., the transition in tides in the U.S. and the U.K. is highly likely to bring a trend shift in the entire world.

Hence it is crucial to consider the impact of the three new tides when speculating on economic performance in 2017. Here, impact refers to influence over various imbalances which shape long-term trends, in addition to short-term effects on economy.

First, let's look into the impact of the shift from "globalization" to "fragmentation". From a short-term perspective, this will certainly downturn the macroeconomy. Since fragmentation negates the global division of labor based on comparative advantage, the economic efficiency is sure to decline. Consequently the distribution of profits derived from the previous efficiency will suffer not only in emerging economies which have enjoyed much of the profits, but in advanced economies including the U.S. and the U.K. (i.e. Import substitution with domestic products causes inflation). Many institutions forecast that the introduction of protectionism in the U.S. Trump administration and Britain's separation from EU will produce significantly negative impact on their macroeconomy.

On the other hand, an action to put the brakes on the excessive globalization is vital as a means to release dissatisfaction of the middle-class "abandoned" by the government in the past. If such discontent intensifies, it could develop to extreme nationalism and geopolitical adventurism. In this regard, if the movement toward fragmentation and protectionism stays "controlled" enough for the governments to indicate their solicitude for the middle-class, it might achieve stable administration of economy and politics in the mid- to long-run.

Secondly, on the impact of the change from "ultra-loose monetary policy" to "fiscal stimulus," this will bring boosting effect on the short-term economy. With the limits of monetary policies in the face of zero interest rates, and the growing adversity of ultra-loose monetary policy, international organizations including IMF, for a long time, have urged the U.S. to take on the expansionary monetary policy given its room for financial growth. If the Trump administration, as pledged, implements major tax reduction as well as fiscal expansion through increased infrastructure investment, these will certainly contribute to underpin the macroeconomy. The same applies to the policy of the May government in the U.K. to extend infrastructure investment in rural regions. The U.S. today, however, enjoys near-full employment, thus further fiscal stimulus would most probably induce inflation and rise in interest rates, which then would result in strong dollars. This would further bring down the manufacturing industry including exporting firms as well as increase in trade deficit. In short, it could cause a consequence to betray the Trump constituency.

What types of influences would be brought to the imbalances in the U.S. by this shift from the "ultra-loose monetary policy" to "fiscal stimulus"? The abnormal soar in asset prices (asset bubble), accompanying the excessive dependence on monetary easing, might be restrained as the interest rates goes up in the future. On another front, what is worrisome is future increase in fiscal deficit and a current account deficit stemmed from proactive fiscal policies. If the substance of investment become exceedingly close to "consumption," the concerns for wasting public funds would intensify. Notably fiscal expansion at the cost of globalization may strengthen the infrastructure foundation for growth as is the case for emerging economies, but growth acceleration by rising technological innovation, of which originally the U.S. is at the comparative advantage, may not be attainable.

Lastly, the shift from "greater regulatory controls" to "deregulation" would produce positive effects in a short term particularly by facilitating resource development such as shale gas. In regards to financial regulation, although it is difficult to abolish already established regulations like the Dodd-Frank Act, by preventing the adoption of new restrictions, or castrating the previous ones, regulatory burdens on financial institutions can be alleviated, enhancing the financial intermediation function. Indeed after the victory of Mr. Trump at the U.S. presidential election, the stock market has anticipated these effects, pushing up the financials and the energy stocks prices, and the stimulant effect has already materialized through the rise in asset prices.

In a medium- and long-term standpoint, impact over the long haul is alarming, such as stability of the financial system in the U.S. and others as well as global warming. It is safe to acknowledge that the current global financial system including the U.S. has become highly resilient to potential risk phenomena thanks to various measures introduced after the Global Financial Crisis. At the same time, concerns have recently grown in regards to imposing further capital rules on major financial institutions, or direct intervention of supervisory authorities to its management. Therefore the correction of extreme regulation, as swing-back of a pendulum, is by no means negative even in terms of financial system stability. However, as previously mentioned, it is a separate discussion whether the American citizens would be convinced with such a direction. Simultaneously in the aspect of environmental regulation, in addition to the long-term burden on the environment, its divergence from the American majority's awareness, can very well cause political instability.

THE BASELINE SCENARIO FOR 2017 GLOBAL ECONOMY AND HOW TO READ TRUMP RISK

What influence in total will the new three trends bring to the global economy in 2017? When looking at the short-term impact on macroeconomy, "globalization" to "fragmentation" will be negative, "ultra-loose money" to "fiscal stimulus" will be positive, and "strengthening regulations" to "deregulation" will also be positive. With these three effects combined, in my opinion, the year 2017 will experience overall positive impact.

As elaborated later, this is because I believe the new American administration's policy shift to protectionism, which represents "fragmentation," will realistically remain limited despite the President's flashy performance. Moreover there is a presupposition that the new administration and the Republican Party will reach a certain level of agreement in the early stages on corporate tax reduction and government expenditure on infrastructure, which lead to the actual fiscal expansion after this autumn. In this case, in the 2017 U.S. economy, a reflation effect from a rise in asset prices expecting fiscal disbursement and deregulation in the first half, and the effect from actual fiscal expansion in the latter half of this year, will drive up the economy. During the same period, the adverse wind of high interest rates and strong dollars will blow, but this is an "outcome" of the reflationary effect, which can partially diminish the effect, but not completely demolish it. Simultaneously it is also possible for advanced economies including Europe and Japan to fully enjoy its benefits through currency devaluation and export increase. To the contrary, emerging nations will experience a year with dwindling economy as increased production of shale gas stagnates crude oil prices, and high interest rates in the U.S. cause capital outflow, resulting in currency depreciation, and consequent inflation and monetary tightening.

Meanwhile, as for risk scenarios, there are several potentials: 1) The president and the Cabinet members, or the Republican Party, have conflicting perspectives, which delays policy implementation for fiscal expansion and deregulation. Consequently the Trump market-rally ends up with a complete rewind, 2) Policies to promote fragmentation are extensively implemented, and this puts downward pressure on the worldwide economy including the U.S. through shrinking trade and rising import prices, 3) America's aggressive attitude towards China and Middle East policies escalates military tension and incurs accidental military conflict, which as a result intensifies the globa risk-off trend, 4) Since slack in the U.S. labor market turns out to be unexpectedly little, increased fiscal expenditure leads to steep inflation and consequent drastic rise in interest rates, which will be followed by significantly stronger dollar.

Among above, (1) and (2) are deemed not as main scenarios but risk scenarios, because I assume that the Trump administration will eventually orient toward realistic policies. Mr. Trump was unique in, rather than talking about sympathy for their feelings "from the top" like many Washington elites, gaining the support of these "abandoned" middle-class by acting and speaking like them, thus, allowing people to see their actions and comments reflected through Donald Trump himself. This is why his tactics in the presidential election are said to adhere to reality shows in which he has been greatly successful.

The question here is how far this type of reality-show performance can be systematically applied as policy measures, for example, in the area of trade. If the ultimate policy targets are confined to restricting rule of origin for the production in Mexico, imposing anti-dumping taxes on certain products from China, and re-enforcing total volume control over automobile import from Japan, the impact on the American and international economy would be limited. In contrast, if a solid action is taken to levy flat tariffs on Mexican and Chinese imports at 35% or 45% respectively, the global economy including the U.S. would fall into a maelstrom. I anticipate that President Trump's intension extends to no more than sustaining his constituency until the next mid-term election just by the "reality show" performance.

OPPORTUNITIES AND CHALLENGES FOR JAPAN

Finally let's examine the scenarios that Japan will encounter in 2017. The baseline scenario reads that under the new trends in the U.S. and others, robust economy maintains itself while pressure intensifies toward inflation. In addition to the improved income environment, with some underpinning factors such as yen depreciation and steady crude oil prices lining up, prices in Japan have a great chance to invert and move upward after finally stopping falling. This would be more applicable if the interest rates in the U.S. enter an upswing trend. For Japan, momentum is at last gathering for a long-dreamed "inflation."

If a more evident sign shows for inflation, the position of the Bank of Japan (BOJ) towards its monetary policy might prove problematic. For example, 1) when to lift the interest rate for 10-year government bonds that is currently controlled around 0%, 2) Concerning the "overshooting commitment" introduced during last year's reform in the monetary policy framework, how to specifically define overshooting, and 3) how to interpret the targets for commitment (be it -0.1% benchmark policy rate, 0%-level interest rates for 10-year bonds, or bond purchase around 80 trillion yen per year, etc.), are not necessarily clear yet. If effective communication does not take place with the market on these points, unanticipated situations might occur such as a temporary surge in long-term interest rates.

Concurrently, with a replacement of the Governor of BOJ approaching in April 2018, the government might add pressure to BOJ to hinder the removal of monetary easing policy. Since a soar in interest rates directly links to substantial increase in fiscal deficit, decisions on the consumption tax raise in October 2019, and attitude toward achieving the goal of a primary balance surplus by 2020 will be questioned. Thus a possibility should be kept in view that BOJ's action for monetary tightening may be delayed. What happens then might be free-falling yen and unstoppable inflation.

The challenge of 2017 lies where, in addition to above inflation scenarios, deflation scenarios also remain as before. If the Trump market-rally winds back, once again an exponential yen appreciation might present itself. Hypothetically if the Trump administration tries to adopt the reality show performance into actual policies, just like China and Mexico, Japan would be another easy target to be a "villain." Furthermore if America's aggressive attitude toward China escalates the military tension, Japan would necessarily face extensively negative impact. By this means, the year 2017 for Japan largely depends on the Trump administration's actions in many ways.

REUTERS/ Aly Song

ASSET MANAGERS MUST PROVIDE FAR MORE DATA TO AVOID RETURN OF 'G-SIFI' THREAT, IOSCO CHIEF WARNS

Peter Elstob, Senior Editor, Securities and Markets, UK & Europe, Thomson Reuters Regulatory Intelligence

The worldwide asset management industry must provide more and better data to regulators, including detailed qualitative information, if central banks are not to revert to narrow numerical measures of the systemic risks the sector poses.

Jean-Paul Servais, who chairs Belgium's Financial Services and Markets Authority and is also one of the two vice chairmen of the International Organisation of Securities Commissions (IOSCO), the standard setter for market regulators, said there was still a wide "data gap" that the asset management industry was failing properly to address.

Until this information gap was closed, the danger remained that central banks and prudential regulators would return to their earlier approach to assessing the systemic risks of what they characterize as 'shadow banking', of which many asset management activities form a significant part.

This approach, embodied in the Financial Stability Board's (FSB) first report on shadow banking, which it presented to the sixth G20 summit in Cannes in 2011 in response to instructions from the G20 countries the year before at their Seoul summit, was going in the direction of simply identifying and listing "non-bank, non-insurance, global systemically important financial institutions (NBNI G-SIFIs)."

PURELY QUANTITATIVE

Speaking to ICI Global's global capital markets conference in London, Servais reminded the assembled asset managers that the FSB's approach from 2011 until last year had been "a purely quantitative approach: Are you, yes or no, [an NBNI G-SIFI], and if so, what are the criteria?" It had, he said, been a question of seeking to "cut and paste" banking and insurance prudential regulation onto the asset management sector.

With the publication of the FSB's June 2016 Asset-Management-Consultative-Document, that approach has undergone a radical, and to the industry welcome, change, the result of a lengthy dialogue between IOSCO and the FSB between 2011 and 2015, as well as two rounds of consultation with industry.

Servais confirmed the FSB's new, IOSCO-influenced approach was "less quantitative and more qualitative", than the "rather mechanical" NBNI G-SIFI approach.

He described it as focusing, initially at least, on "a good mapping" of potential systemic risk. But he cautioned that the new emphasis on collecting far more data and information than previously would be challenging both for regulators and for the industry. However, producing that increased and enhanced data, and supplying regulators with "comprehensive, global figures" was the only way to prevent a return to the "mechanical" quantitative approach, he said.

"If the industry fails to play its role in filling the data gap, there is a danger that global prudential regulators would return to the quantitative approach of identifying NBNI GSIFIs, which at the moment remains in the background," he said.

"Everybody must be open-minded about the capacity to fill the data gap ... for which we still need a learning curve, in order to identify the real systemic risk," Servais told the asset managers.

FSB'S NEW APPROACH

In its June paper, the FSB identified a number of "residual risks" that asset management could pose, in relation to liquidity mismatch, leverage, operational risks, and securities lending.

Liquidity mismatch between funds' investment assets and their units' redemption terms and conditions. Residual risks include whether existing regulatory information and public disclosures are sufficient to assess the degree of liquidity transformation and its systemic implications; whether the liquidity risk management practices are appropriately calibrated to address potential risks; and whether the tools in place would be sufficient to deal with stressed market conditions.

The FSB made nine recommendations to securities regulators for addressing these risks, and said IOSCO should "review its existing guidance and, as appropriate, enhance it" in relation to many of the improvements and enhancements included in the recommended policy proposals.

The use of leverage by funds, which the FSB said could create and/or amplify risks to the global financial system through direct and indirect contagion channels. Although most jurisdictions already limit leverage for certain types of funds, or have disclosure and reporting requirements to monitor risks within individual funds, regulatory and supervisory measure did not always support overall financial stability by, for example, intervening when leverage built up across all or a segment of funds.

Three of the recommendations relate to leverage risks, of which two are addressed to IOSCO for 'operationalization'.

The operational risk and challenges in transferring investment mandates or client accounts. In stressed conditions, operational difficulties with transferring client accounts could occur through the termination of derivative contracts, when replacing ancillary services, and due to legal difficulties with transferring client accounts. The FSB recognized that historically there have not been serious operational incidents during stressed conditions, which made it difficult to assess how material such difficulties would be.

The FSB said while a number of regulatory and supervisory tools and market practices were in place to mitigate or reduce the likelihood and impact of operational difficulties, potential gaps might exist between their scope and focus and the sources of actual operational difficulties within and across jurisdictions. The gaps included insufficient information on funds' OTC derivatives and separately managed accounts (SMAs), and the failure of asset managers' business continuity plans to cover all potential sources of operational difficulties in transferring client accounts, especially in stressed conditions.

The FSB made a single recommendation in relation to these operational risks, stating that regulators "should have requirements or guidance for asset managers that are large, complex, and/or provide critical services to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and transition plans, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions."

The securities lending activities that asset managers and funds carry out. Here, too, the FSB made a single recommendation, that regulators "should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients."

The consultation closed at the end of September, and FSB will finalize the proposals early next year.

REUTERS/Thomas Peter

PARTNERSHIP

Servais said there was now, through what he described as the FSB-IOSCO "partnership", a clear dialogue between the world's prudential and market regulators.

"I don't see any kind of conflicts of interests between the FSB and IOSCO," he said.

What was happening was that the market regulators in IOSCO were helping the prudential regulators at the FSB to understand "the real issues" when it came to systemic risks in assetmanagement, and that included identifying asset management operations that did not necessarily pose systemic risks. For example, while liquidity mismatch was certainly an important and topical issue, prudential regulators' concerns about leverage could be overdone.

"Everybody is speaking about leverage. Maybe we have to explain that not everybody is a hedge fund ... A lot of the time there is a lot of misunderstanding about this," Servais said.

Prudential and market conduct regulators were no longer working in silos, as they had before the 2008 financial crisis, the IOSCO vice chairman said. They did not regard each other as competitors, and there was a more open-minded approach on both sides.

"This also means building trust and confidence to promote the objective of financial stability, investor protection and market integrity — all part of IOSCO's global mission statement," he said.

"It means also, as far as IOSCO is concerned, to be able to develop, implement and promote internationally recognized, consistent standards to meet these objectives, and [cooperation among regulators].

BRAVE IOSCO

Dan Waters, ICI Global managing director, said IOSCO's influence on the FSB's work in relation to asset management was not always sufficiently understood.

"I daresay, without their intervention we might well be living in a world where asset managers were being under the direct supervision of central banks. But that's not the way this has gone, and IOSCO was quite brave in the summer of 2015 to stand up and say to the world the work on [NBNI] G-SIFIs is not where we should be focusing, we need to look at these wider issues," Waters told the conference.

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GLOBAL BRIBERY STANDARD TAKES EFFECT IN EFFORT TO LEVEL PLAYING FIELD; TRUMP, BREXIT CHALLENGES LOOM

Richard Satran, Financial Journalist, Thomson Reuters Regulatory Intelligence

New global bribery rules have taken effect under a set of standards agreed by 37 countries in the ISO consortium. The impact is seen as timely in holding countries accountable even as political winds shift away from regulation as some members of the consortium pull back on cross-border accords and enforcement.

The ISO, or International Organization of Standards, lays out a set of rules similar to those followed in the United States and Britain, two of the countries whose anti-corruption rules are the most stringent. The global standard implemented last month provides continuity as both countries have been hit by political upheavals that could challenge their role as global leaders in fighting the $1 trillion a year raked off by graft and corruption.

"Even if President-Elect Trump wavers on FCPA, the international standard will help. Most corporations that are big enough to be at risk for anti-bribery violations are at risk not only for US FCPA violations, but also for equivalent anti-bribery and anti-corruption requirements in other countries," said Dan Zitting, chief product officer for audit and risk firm ACL.

GLOBAL COOPERATION SPURRING CHANGE

The new international standard encourages anti-bribery cooperation, Zitting said, although "the big question that remains is whether potentially reduced levels of fines could reduce the urgency of addressing bribery risk, since enforcement action by the US DOJ is far more material in terms of financial penalties than typically seen in other countries."

The rules also come at a time when U.S. banks and brokers are feeling the heat of FCPA enforcement as never before with large cases settled against JP Morgan for alleged hiring favoritism in China, and investment firm Ochs-Ziff for alleged payoffs of government officials in a number of African nations.

Global cooperation has turned up multi-billion dollar bribery schemes in a number of countries, most notably Brazil and Malaysia, and also cases implicating U.S. financial firms as never before. The rise in bribery cases comes as global enforcement agencies increasingly share banking transaction information and other data in tracking down alleged corruption.

REUTERS/Corbis

FOR U.S., U.K. NOT A BIG CHANGE

The ISO agreement is non-binding, but countries that sign on the standards will merit an ISO standards certification that could facilitate trade and international transactions. The standard incorporates requirements to create compliance programs and systems of monitoring them, as well as other protections widely used already by U.S. and U.K. firms.

The new rule, ISO 37001:2016 "sets out requirements and provides guidance for a management system designed to help an organization to prevent, detect and respond to bribery and comply with anti-bribery laws and voluntary commitments applicable to its activities."

While the ISO standards will not be a big change for American compliance programs that already follow rules of U.S. regulators, it could spur laggards to meet U.S. rules, and also encourage U.S. enforcement to stay the course during the new Trump administration. U.S. business has long complained that its global operations are hampered by rules that leave them vulnerable to competitors from less-regulated domiciles. FCPA experts see U.S. firms that already adhere to the standards lending support, and even pushing the new U.S. administration to stand behind the push against global corruption.

ONE RULE SET FOR ALL GLOBAL POSITIONS

"If you are a large multinational operating in different parts of the world under multiple accords in all of those different countries this should satisfy the regulatory requirements," said Zitting. "It will help normalize your operations in different countries."

Zitting called the ISO standard "the first meaningful coordinated international effort" to tackle bribery and corruption in a single set of rules in a way that satisfies requirements in all jurisdictions. The ISO sees the adoption of the global standard balancing the scales toward more universal bribery rules.

"The FCPA effectively tilts the playing field against us in foreign business transactions. But the global landscape gradually may be changing. Corruption prosecutions outside the U.S. are becoming more common, and many foreign governments have signaled a change in perspective by enacting new and stricter anti-corruption laws," said Dulce Foster of Fredrikson & Byron in a blog recent blog.

In a sign that other countries are supportive, the ISO standard passed by a 91 percent vote of the countries in the ISO agreement. Neill Stansbury, Chair of the ISO project committee developing the standard, said the strong result of the vote gave the committee even greater confidence in the standard's ultimate potential.

"The overwhelming positive vote on the draft version of ISO 37001 gives us further confidence that it will be an effective tool to help organizations of all kinds take effective measures to combat bribery in all its forms," said Stanbsury, in an ISO posting. "It is little wonder, then, that the draft version of a new ISO standard in development, which aims to help organizations fight bribery, got an overwhelming 91 percent vote of confidence from the ISO members involved in its creation."

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REUTERS/Vasily Fedosenko

REGULATORS SHOULD KEEP PACE WITH THE USE OF ARTIFICIAL INTELLIGENCE IN FINANCIAL SERVICES, REPORT FINDS

Ajay Shamdasani, Senior Regulatory Analyst, Thomson Reuters Regulatory Intelligence

Artificial Intelligence (AI) has the potential to bring about dramatic changes in the financial services industry, a new survey has found.

Such developments could help financial institutions improve their compliance and screening programmes and remove the potential for human error, although the adoption of these solutions will hinge on regulators' ability to keep pace with technological changes. In the Asia-Pacific region, the majority of survey respondents expressed doubts about whether local regulators were up to the task.

The survey, conducted by law firm Baker & McKenzie, found that 75 percent of the companies questioned did not believe regulators had kept pace with the immense technological advances made during the past decade. The survey found that, a result, firms in the Asia-Pacific region had been cautious in their own adoption of such technology.

Respondents called for closer collaboration between regulators in the region and fintech developers.

"This is a call to action for all of those with a stake in fintech, including start-ups, financial institutions, regulators and consultants such as those in the legal profession," said Gavin Raftery, a partner with Baker & McKenzie in Tokyo. "At a minimum, new technologies need to be understood as they come on stream, and information sharing and collaboration needs to be embraced to keep pace."

The report said that AI could bring about competitive improvements in the financial sector, as it presented the opportunity for software to learn from patterns and behaviours and act accordingly.

As one of the fastest growing areas in fintech, such technology offered competitive and innovative advantages to early adopters, the report said. Firms in the regional fintech hubs — Hong Kong, Singapore, Sydney and Tokyo — might therefore be better placed to benefit.

Raftery said new market entrants would be able to disrupt the financial services world by harnessing AI for platforms as diverse as investment research and risk management. "That is why we see many financial institutions actively involved in incubator and accelerator programmes: to stay abreast of change, identify investment opportunities and to tap into top talent," he said.

COMPLIANCE USES

For the compliance, legal and risk management fields, AI was an opportunity to automate various functions and reduce conduct risk, Raftery said.

"This is a very topical issue for many financial institutions as there have been some very large fines handed down globally for misconduct and compliances breaches by traders," he said.

Indeed, such technologies may already have helped the compliance function to deal more effectively with anti-money laundering, know-your-customer and countering terrorist financing issues.

"AI has tremendous uses in the AML, KYC and CTF space, especially for customer onboarding and ongoing transaction monitoring, because it can pick up on patterns and trends in real time that even an analyst with years of financial crime experience may not detect in time, if atall," said Bill Majcher, chief executive of EMIDR in Hong Kong. "At the end of the day, [analysts] are only human... Computers are not perfect, but solving for overheating and power surges, they can keep grinding on, searching for patterns while the rest of the world sleeps."

Raftery said, however, that AI would need to be introduced carefully, and that thorough testing was needed to ensure that institutions, regulators and policymakers alike understood the potential downside of such technology. "If and when introduced, the role of compliance officers and in-house counsel will also need to evolve and the integration of tech-savvy personnel into these teams will be important," Raftery said.

As an example, high-frequency trading (HFT) is predicated on algorithms which employ AI, but developments in AI have taken this technology beyond simply enabling fast transaction execution.

"Many fintech start-ups are now working with AI on various forms of machine learning, for example to detect trading and market sentiments. It is important for those developing AI platforms to work closely with regulators to ensure transparency and the sharing of knowledge and experiences," Raftery said. "Regulators will not easily authorise systems and will come down hard on market participants that introduce new risks to the market."

LOOKING AHEAD

The survey polled 424 finance executives, of which 67 came from across the Asia-Pacific region. Those polled saw AI mostly as an opportunity for financial services providers, although one not without inherent risks.

Survey respondents said that over the next three years, the impact of AI would be felt most keenly in areas such as trading, financial analysis and information technology. Many participants also expected machine learning to affect risk assessment, credit assessment and investment portfolio management.

Risk assessment and financial research were the areas where firms said they were most likely to invest and experiment with machine learning applications in the near future. Half of the international financial services companies interviewed expected some level of AI to be introduced into their risk assessment functions during the next three years, although in Asia that figure was just 38 percent. The cost of development remained the main obstacle for building AI or machine learning capabilities, followed by a shortage of skills to develop and maintain AI systems.

Survey respondents also said AI would encourage market diversity, with more start-ups and small and medium enterprises (SME) entering the market. Some, however, expected this to have a negative effect on market stability as new entrants disrupted the established order.

More than two-thirds of those polled said their own roles in financial services would be substantially or completely changed by AI and machine learning within the next 15 years.

NEW TECHNOLOGY CANNOT COMPLETELY REMOVE THE POTENTIAL FOR MISCONDUCT

Some aspects of the financial services world, however, may be more resistant to change. The report found that despite the introduction of new technology, it would be difficult to remove completely the potential for misconduct by traders.

"Financial institutions have been fined billions of dollars because of illegality and compliance breaches by traders. A logical response by banks is to automate as much decision-making as possible, hence the number of banks enthusiastically embracing AI and automation," said Arun Srivastava, a partner with Baker & McKenzie in London. "But while conduct risk may be reduced, the unknown risks inherent in aspects of AI have not been eliminated."

This is an edited version of an article originally published on the Thomson Reuters Regulatory Intelligence platform.

REGULATORS AND INDUSTRY SHOULD SHED FEAR OF FINTECH

Ajay Shamdasani, Senior Regulatory Analyst, Thomson Reuters Regulatory Intelligence

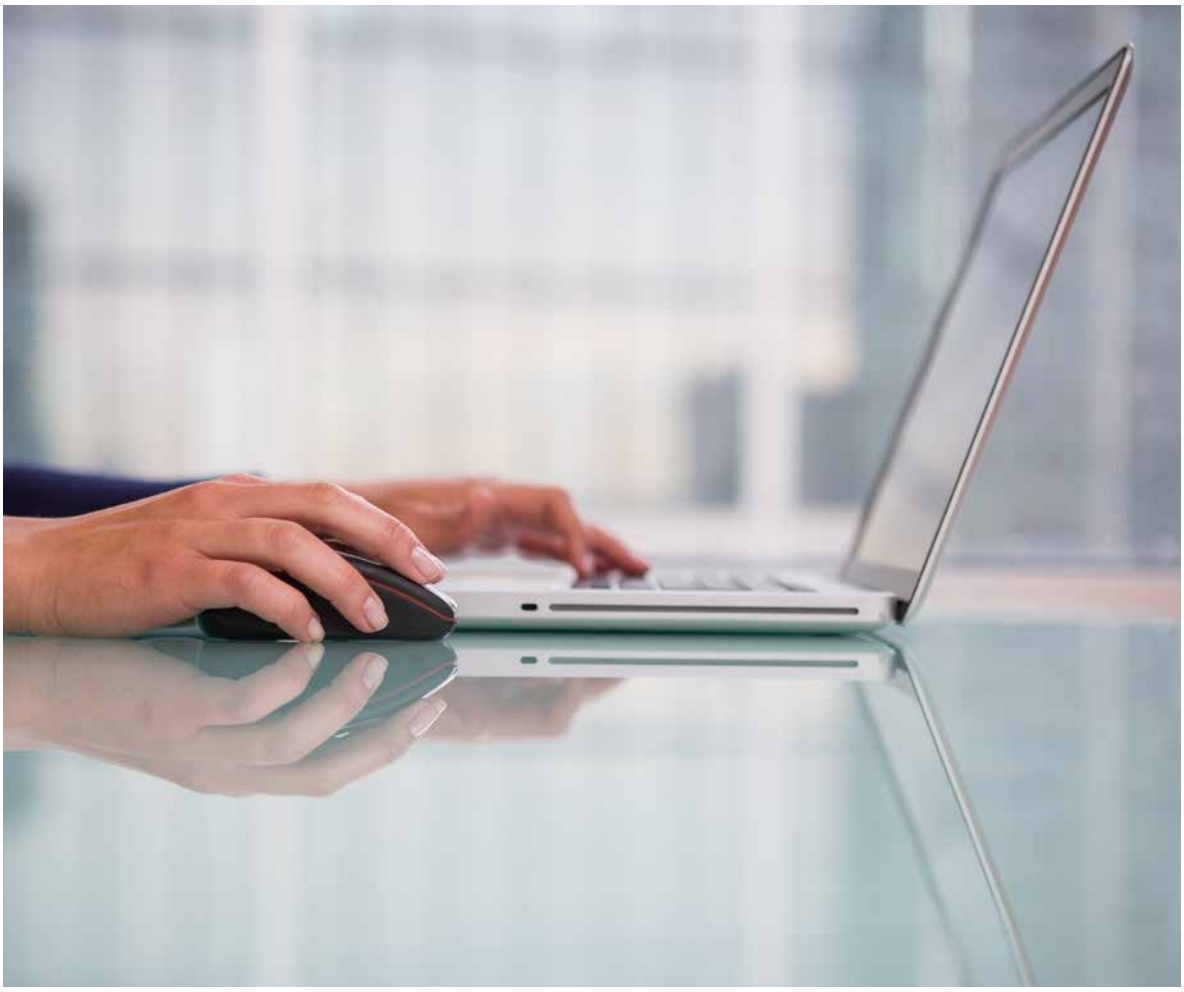
The wide-scale adoption of financial technology (fintech) is being held back by regulators and financial institutions because of fears such technologies pose an undue risk to the financial system, panellists at a recent conference in Dubai said. In addition, a lack of understanding of technology is preventing the industry from embracing it, they said.

"Compliance officers as well as technologists...need to come together and understand what these technologies are bringing," said Nishanth Nottath, the regional head for anti-money laundering (Middle East and North Africa) at HSBC Bank Middle East.

Nottath said: "Many have embraced fintech...but the sense of euphoria is giving way to a sense of caution. Slowly, regulators, one by one, are saying 'we need to be careful about what we are dealing with'."

He said that with most new technologies, there was a sense of irrational exuberance, followed by a more cautious approach.

"Anything that is unreasonable exposes the financial system to risk, we must be careful about it. For example, Australian regulators have recently said that 'digital wallets' [for crypto currencies] are the same as money service businesses (MSBs) and must be treated a certain way," he said. "Similarly, larger banks are asking: 'by [using] fintech, would I start exporting risks through my correspondent banking network? Do I end up, therefore, polluting my otherwise clean correspondent banking relationships?"



REUTERS/Yuya Shino

Nottath said, however, that there were benefits to be had from using fintech for AML and KYC compliance — especially regarding trade finance and cross-border payments, where the current infrastructure is outdated and cumbersome.

Still, firms should evaluate the impact using fintech would have on their organizations, he said.

"If you are using disruptional technologies, you must evaluate them from end-to-end; from an operational perspective and a technical perspective. You need to have long talks with your information technology (IT) and operations colleagues to see how information gets out of the institutions and how it enters the institution, upstream and downstream."

FEAR OF THE UNKNOWN

A recurring stereotype of compliance officers, money laundering reporting officers (MLROs) and in-house or general counsel at firms worldwide is that they are resistant to change and unwilling to try new approaches that might better help in the execution of their duties. Much of that has to do with the degree of personal legal liability that such roles often have, and the enactment of the USA PATRIOT Act and the Foreign Account Tax Compliance Act (FATCA).

"'Neophobia' or fear of the new is not a positive contributor to progress. Some hide [their] neophobia as being cautious. Nowhere is that more present than in compliance officers, more than in any other set of individuals in the financial sector. We are constantly allergic to new things," said P. Faisal Islam, fintech and AML compliance director at the pfi.io Advisory, and one of Nottath's co-panellists.

Islam said compliance officers should stop thinking that new financial "products constantly pose a risk to the financial system".

"Fintech is not a threat. It will not threaten your [banking] business. Sometimes, you just need to reconfigure [your systems] to reduce doubts," he said.

Islam said that if institutions introduce fintech into certain areas of their compliance functions, it was because there had previously been a lack of it.

"Fintech is servicing a market that has been underserved by banks," said the panel's moderator, Anthony Rodriguez, chief risk officer at AFEX.

WILL AI DISPLACE COMPLIANCE OFFICERS?

Islam said that from an AML and countering terrorist financing (CTF) perspective, there were things machines were simply better at.

"Artificial intelligence (AI) can sift through transactions in milliseconds and come up with results that are actionable. The output of those transactions results in better transaction reports and better escalation mechanisms. Humans are highly arrogant and inefficient beings. It is only a matter of time before it [compliance] is taken over by machines," he said.

Nottath, too, said that AI had "really come up" and was showing a "new level of consciousness" and savvy that meant it could genuinely aid the compliance profession in detecting AML and financial crime breaches that the human eye might previously have overlooked.

"We have all practiced transaction monitoring in the manual sense, but now IT is a real force to be reckoned with. Banks are expending a lot of money and effort, as well as fintech companies, to see how best we can use technology ... to manage risk and [improve] customer experiences," he said. "For compliance officers, it is a time for change as we all need to learn about such new technologies and spend more time with our IT colleagues ... to take banking to the next stage."

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