THE ASEAN REGULATORY ENVIRONMENT 2017

ACTING IN A TIME OF UNCERTAINTY

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2016 was a year of geopolitical unrest and change, with repercussions that extend to the regulatory sphere. Despite being on the other side of the world, banks and financial institutions in ASEAN need to continue to stay on top of regulatory developments in the West and be prepared to adapt their businesses to these changes. Increasing regulatory demands also mean that organizations need to look to new ways to streamline and remain efficient – technology could provide the solution to this challenge.

The ASEAN Regulatory Summit, running on 9th May in Singapore, will discuss these issues and more. This report is comprised of Thomson Reuters Regulatory Intelligence articles and contribution from our thought leadership partner, EY, 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/ASEANRegulatorySummit2017

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FUNDAMENTAL REVIEW OF TRADING BOOK MAY DISCOURAGE BANKS FROM RETURN TO PROPRIETARY ACTIVITIES

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

The Basel Committee's Fundamental Review of the Trading Book (FRTB) is likely to discourage banks from returning to the proprietary trading business given the punitive capital requirements and the amount of work that they need to do, consultants said.

The big question following Donald Trump's election win has been whether his administration will repeal the Dodd-Frank Act, and specifically the Volcker Rule, said Keith Pogson, senior partner, Asia Pacific financial services at EY in Hong Kong. But the additional capital requirements under FRTB would be the main determinant as to whether banks will return to the prop trading business, he said.

"Even if [the] Volcker Rule is removed, it will not be a major move back to [the] prop trading [business] because of the capital requirements. So the only real savings on the repeal of [the] Volcker Rule is the reduction of paperwork. That will not necessarily put a largeamount of prop trading into the business. The larger driver of behaviour is capital consideration, i.e., howmuch capital you need rather than a certain type of business as required by Volcker Rule," he said.

ELIMINATING CAPITAL ARBITRAGE BETWEEN TRADING AND BANKING BOOK

The financial crisis exposed weaknesses in the framework for capitalising trading activities, and the level of capital required against trading book exposures was insufficient to absorb losses. FRTB seeks to achieve three main objectives, chief of which is to eliminate capital arbitrage between the trading and banking book by reducing the transfer of risk between the two books.

BANKING BOOK

The Basel Committee on Banking Supervision (BCBS) has proposed prescriptive rules for the allocation of traded assets under FRTB which leave banks with few options, while subjecting them to significant restrictions on the transfer of risk between the banking and trading book, said Kishore Ramakrishnan, director of consulting at PwC in Hong Kong.

For instance, all equity investments in funds, all unlisted equity investments, all real estate holdings, all the credit to retail and the SME sector have to be recorded and captured in the banking book. All these instruments must be part of the banking book by mandate and they cannot be risk-managed, Ramakrishnan said.

"Even if banks trade in these instruments, they have to trade within the banking book but they will be subject to the regulatory capital that applies to the banking book," he said.

TRADING BOOK

There are other instruments which, by mandate, must be captured in the trading book, Ramakrishnan said. They include listed equities, any transactions which involve short-term resale of the instruments, any transactions which profit from short-term price movements, any transactions which banks attempt to lock in the arbitrage for profit and any hedging risk that arises from the instruments mentioned above.

Banks will also be subject to a host of requirements should they attempt to transfer the risk between the trading and banking book, Ramakrishnan said. These include internal approval by senior management, regulators' supervision, public disclosure and thorough documentation.

Transfer of risk between trading and banking book will be allowed but only under very few circumstances, such as permanent closure of a trading desk; termination of a business activity corresponding to a specific instrument in the portfolio in question, and changes in accounting standards which result in variations in the way profits and losses are captured.

"These are considered extraordinary circumstances under which a risk transfer is permitted between the trading and banking book," Ramakrishnan said.

MAKING THE STANDARDISED APPROACH MORE RISK-SENSITIVE

The second objective of FRTB seeks to make the standardised approach to market risk calculation a credible alternative to the internal risk-based approach (IRB). Typically banks quantify market risk changes using either the standardised approach, to which a haircut applies, or their internal risk-based approach.

Regulators have questioned the IRB approach largely because the parameters used by banks were subjective and subject to regulators' approval. The BCBS has therefore proposed to strengthen the standardised approach by making it more risk-sensitive through aggregating the risk charges for delta, vega and curvature risk, according to Ramakrishnan.

"In addition to delta, vega and curvature risk, BCBS has also included default risk charges, which attempts to reduce the gap between the standardised approach and the IRB approach for credit risk,' he said.

ADDRESSING THE WEAKNESSES OF THE IRB APPROACH

FRTB also attempts to address the weakness in the existing IRB approach by requiring internal model testing to be carried out at individual trading desk. BCBS also recommended that the value at risk (VaR) approach be replaced by the expected shortfall approach.

Pogson said banks which have been using the IRB approach would need to rebuild the modelling of the standardised approach equivalent so that they can work out the capital floors. Rebuilding processes for the standardised approach will involve building the models, and some heavy computation and data work to ensure that the appropriate data set can be obtained.

"It's about building data engines. There's a lot of work to be done. Banks will then work out the consequences and review their businesses. Can they make money and get the return on capital that they need to achieve given the cost of capital of running the business?" he said.

CAPTURING DATA

The sheer volume of data which banks are required to capture and the level of granularity of the data required by regulators would be one of the main challenges to banks, Ramakrishnan said. Defining the individual trading desk for the purpose of FRTB is also a significant challenge, given the amount of computation required for the standardised approach and the internal risk-based model approach.

"That will put burden on the systems and technology infrastructures. How the market risk capital charge will vary for the new risk-sensitive standardised approach and the internal risk-based approach will provide banks with insights on how FRTB will affect the front office, finance, and compliance, among others," he said.

ASSESSING THE IMPACT OF FRTB

Banks have begun their implementation strategy for FRTB by initiating desk-level pilot analyses to assess the impact of FRTB on the front and the back office functions.

The desk-level pilot analyses involve picking a few samples of trading desk and subjecting them to the standardised approach or internal model approach to determine capital and market risk charges. The pilot analyses will also help banks to identify compliance gaps in their processes, systems and infrastructures. All this will determine the steps that banks need to take to implement FRTB at individual trading desk internationally, Ramakrishnan said.

FRTB A DISADVANTAGE TO INTERNATIONAL BANKS

One of the important impacts of FRTB on the large international banks could see a further reduction in their willingness to take on further credit risk and exposure particularly to the SME sector in emerging markets because of their disadvantaged position compared to the domestics banks, Pogson said.

"The concept of capital floors based on the standardised approach makes international banks become more worried about being exposed to lower grade risk in emerging markets," he said.

Pogson said given the disproportionate impact on SME lending, it remains to be seen whether central banks will try to influence the supervisory side of bank regulators.

"It's a question of whether we will see some of that, because of the demanding consequences of increased capital requirements on SME market lending and credit," he said.

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

ASIAN BANKS FAR FROM READY FOR IFRS9 IMPLEMENTATION

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

Asian banks are far from ready for implementation of the International Financial Reporting Standard 9 (IFRS9) unless local banking regulators are able to ascertain how impairment will be treated for provisioning and capital purposes, a consultant said.

Despite being just nine months away from the January 1, 2018 implementation date, many Asian banks find themselves stuck with many unresolved issues arising from having to comply with IFRS9. This is partly because some banking regulators in Asia started looking into IFRS9 a bit late, unaware of the sizeable potential impact it may bring, said Simon Topping, head of regulatory practice at KPMG China.

"Some banking regulators [in Asia] were a bit late to start looking at IFRS9. They were asking banks to calculate and submit the numbers and they [now] realised the change for some is quite big; it shows the impact is bigger than what banking regulators had initially anticipated," he said.

TREATMENT ON PROVISIONING

Various reports have shown that the adoption of IFRS9 will increase the amount of provisioning by 25 percent or in the range of 20 to 30 percent, depending on the banks and the countries in which they operate. Assessments of individual banks have shown that some provisioning figures are as high as 100 percent, according to Topping.

It remains unclear whether Asian regulators will regard the impairment allowance as provisions or whether they will require it to be topped up or calculated in another way, Topping said.

"Unless regulators are clear on those areas, you can't say the issues on IFRS9 are dealt with," he said.

Some banks are using the simpler approaches to calculate the provisioning, but Topping warned that the numbers may change again in a few years' time if they retrospectively adopt the more advanced or sophisticated approach.

CAPITAL TREATMENT

Asian regulators have also not indicated how capital will be treated under IFRS9. The Basel Committee on Banking Supervision on January 13 concluded a consultation paper on capital treatment under IFRS9, but has yet to finalise its decision.

IFRS9 requires the impairment figures to be deducted from Core Tier 1 capital which is consistent with the existing treatment on provisions, but there are concerns that Core Tier 1 capital will be substantially reduced if provisions increase.

The Basel paper has proposed to spread out the effects of the provisioning on Core Tier 1 capital over a three-year period rather than over a year. That will have the net effect of slowing down the impact on banks' capital.

"Because the increase in provisions that results from IFRS9 has to be deducted from Core Tier 1 and because that number is higher than expected, what Basel is worried about is that global banks' core capital will fall significantly if the provisions are deducted from Core Tier 1 over a one-year period. If banks' capital falls, it could affect their ability to lend," Topping said.

Asian regulators, including those in Hong Kong and Singapore, will be able to exercise their discretion once the Basel Committee is able to finalise its decision on the capital treatment under IFRS9.

DIFFERENT IMPLEMENTATION TIMELINES

Another major challenge is the different implementation dates for banks operating in different Asian jurisdictions. Some banks are following the January 1, 2018 date recommended by the International Accounting Standards Board (IASB) but others such as those in Indonesia and Thailand have indicated that they would implement IFRS9 a year later.

While some banks have bank-wide IFRS9 programmes, they may carry out implementation according to the timelines set by their home country regulators. The more tricky situation arises when some banks operating in certain jurisdictions may have to implement IFRS9 by January 1, 2018 but may only adopt the new accounting standard in their home country a year later. This could potentially happen to an Indonesian or Thai bank with operations in Singapore which is following the January 1, 2018 timeline.

EXPECTED CREDIT LOSS MODEL

Banks whose head offices have yet to implement IFRS9 would be required to introduce an expected credit loss (ECL) model, which they should already be doing, said Seah Li Yun, assurance partner at EY in Singapore. But these banks may find themselves left with only a short period of time to identify gaps or make the necessary adjustments to implement the ECL model locally.

"Even with the head office taking the lead for implementation, it is important for the banks to understand the model and the methodology decided at their head office so as to identify any adjustments required for local implementation," she said.

MORE WORK TO BE DONE

There remains a variety of tasks which Asian banks have yet to carry out to comply with IFRS9, Topping said. For instance, they would need to understand the business impact of the provisioning figures, such as how it will affect the pricing of some products. They would also need to work out how IFRS9 will be integrated into the risk management framework. A more mechanical process of producing the numbers has to be in place as opposed to the use of an excel spreadsheet, a practice which remains in use at many banks to produce the provisioning figures. Banks would also need to concern themselves with how they make disclosure on the methodology they will adopt and the factors that influence their decisions.

While Asian banks are generally considered to be behind European banks in IFRS9 implementation, certain jurisdictions, such as Australia, Malaysia, Singapore and Taiwan, are considered to be leading the pack, according to assessments carried out by KPMG China. The second category includes China, Hong Kong and the Philippines, whereas Indonesia and Thailand are considered to be the slowest in IFRS9 implementation.

Speaking in the context of Singapore, Seah said most banks in Singapore would have begun their IFRS9 gap and impact analysis two years ago, although the stage of development for implementation may differ among banks. The larger Singapore-incorporated banks are likely to be building the expected credit loss model. Most subsidiaries or branches of banks incorporated in other locations are waiting for their head offices to finalise the methodology and approach before deciding the next course of actions.

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

REUTERS/ Sean Yong

ASIAN BANKS AWAIT RESPONSE OF LOCAL REGULATORS TO POTENTIAL RELAXATION OF RULES IN U.S.

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

Against the backdrop of increased regulation in the EU and potential rolling back in the United States, banks in Asia are waiting to see how their local regulators will react to such conflicting influences.

Donald Trump's administration has given few specific details financial regulations that will be amended or repealed, other than those listed in the president's campaign statements and his vow to substantially revamp the 2010 Dodd-Frank Act. Regulatory reforms in the EU have meanwhile shown no signs of relenting.

DIFFERENT DIRECTION AND REGULATORY PHILOSOPHY

Rebecca Thorpe, head of Asia at consultancy Bovill in Singapore, said it would be interesting to assess how the different direction and philosophy emerging from the United States and the EU affect the level of regulations in Asia.

Industry officials have speculated about the United States making changes to encourage banks to be able to lend more, a view espoused publicly by Steven Mnuchin, the recently confirmed Treasury secretary. He believes U.S. banks have been constrained from lending as part of the regulatory reforms following the financial crisis.

Thorpe said: "If this happens, it could lead to an increase in overall market activities, particularly the mortgage market, as well as potentially improve the rates on loans as well. That will improve market competitiveness as more loans are extended. Asian regulators may do the same."

Simon Topping, head of regulatory practice at KPMG China, said Asia faced a different situation from the United States. He cited Hong Kong as an example where the Hong Kong Monetary Authority is trying to suppress lending by applying the counter-cyclical buffer at a time when the rest of the world is worried about banks having insufficient capital to lend.

Thorpe said if Trump was successful in deregulating, and supervisors in other jurisdictions are able to see the positive impact of deregulation on the wider economy, they are likely to follow suit.

Thorpe believed Asia has the advantage of being able to move quickly to deregulate, if there is any benefit of doing it, unlike the EU where it takes a long time for the legislative process to change. She was also quick to point out that Asian regulators, if they were to embark on deregulation, would consider it carefully only if it is proven to benefit the local economy.

"I think the Monetary Authority of Singapore will do it if it benefits the local economy. We have seen a recent example of MAS working to deregulate in its proposals to simplify the authorization process and regulatory framework for managers of venture capital funds," she said.

Singapore and Hong Kong, two of Asia's leading financial centres, have always been applauded for their approach of cherry picking new regulations released by the Basel Committee for Banking Supervision and introducing those beneficial to their respective markets, Thorpe said.

"The Singapore and Hong Kong regulators have got the right balance between protecting the local markets and investors, while not overburdening new entrants with new regulations. MAS especially has got that balance really well," Thorpe said.

U.S. DEREGULATION HAS NO IMPACT ON ASIA

Topping's view was deregulation in the United States was unlikely to lead to similar actions in Asia. Areas where the United States has been talking about cutting back on regulations tend to be those where Asia has nowhere near the level of equivalence, such as consumer protection, which is heavily regulated in the United States, he said.

"Banks in Hong Kong and Singapore may be hoping that HKMA and MAS will deregulate. I don't think all the regulatory pressure is going to come off. Banks in Asia still have to worry about [International Financial Reporting Standard 9], interest rates risk, financial crime and AML. There are no signs of MAS and HKMA pulling back on areas that are important," he said.

CAPITAL REFORMS MAY SLOW DOWN IN ASIA

Other observers believed Asian regulators were just waiting to see what form any deregulation in the United States would take. One expectation is some capital reforms may slow down if the United States starts to deregulate. The impact on Asian regulators would probably see a slackening in capital reform of initiatives such as the Fundamental Review of the Trading Book and Basel IV, said Keith Pogson, senior partner, financial services at EY in Hong Kong.

"Asian regulators may slow down in their implementation of the FRTB [as a result of deregulation in the United States], as the capital floors for the standardised approach may not be set. European regulators have also yet to agree on the capital floors," he said.

CONSUMER PROTECTION RULES

Consumer protection is another area where the United States may want to relax some of its regulations but Asian regulators are unlikely to follow suit, Pogson said.

"It's controversial whether consumer protection rules will go away. I don't think we will see Asian regulators moving swiftly [to get rid of consumer protection rules] because they want to see how MiFID II plays out. Regulators will only remove consumer protection rules if consumers want it to be removed. Consumers are voters. Consumer protection is a more political topic and a dangerous topic to play around with," he said.

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

REUTERS/Jason Lee

REPEAL OF VOLCKER RULE COULD REDUCE ADMINISTRATIVE BURDEN FOR ASIAN, GLOBAL BANKS

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

A repeal of the Volcker rule could potentially reduce regulatory and administrative burden for Asian and global banks with a presence in the United States despite the U.S.-centric nature of the rule, a consultant said.

The Volcker rule was contemplated in the aftermath of the financial crisis to restrict investment banks from risk-taking activities witnessed during the financial crisis. It has generally been seen as the first rule under the Dodd-Frank Act most likely to be repealed as part of President Trump's de-regulation strategy.

A number of banks in Asia, including both the global players with activity in the United States and Asian banks with U.S. operations have to comply with the Volcker rule.

Keith Pogson, senior partner, financial services at EY in Hong Kong, said a repeal of the Volcker rule would be an obvious win for these banks as it would mean a reduction in administrative and regulatory burden.

REMOVES ADMINISTRATIVE WORK, CAPITAL SAVINGS

The Volcker rule has effectively been an administrative process, Pogson said, largely because compliance requires banks to fulfil substantial paperwork and documentation. But the Volcker rule has become redundant today largely because the cost of capital in today's capital framework and the capital requirements under the Fundamental Review of the Trading Book made it expensive to run a prop trading desk, he said.

The upside of repealing the Volcker rule is that it removes administrative work for banks and regulators. Given that banks do not have to incur costs in carrying out the administrative work for complying with the Volcker rule, this will translate into capital savings for banks, Pogson said. He believed regulators are likely to accept the repeal of the Volcker rule because the capital requirements are so high that banks are unlikely to rush into prop trading.

"That's why removing prop trading is an easy win, because [the] Volcker rule has served its purpose, but today it's obsolete," he said.

THE VOLCKER RULE HAS BECOME OBSOLETE

During the post-crisis days, the Volcker rule was considered a blunt tool, but it did what it needed to do from a regulatory standpoint. Regulators have since stepped up prudential supervision and there have also been substantial reforms in the capital framework. This has meant higher levels of capital required of banks and more specific focus on the amount of capital they are required to hold to cover specific risk, Pogson said.

"If today you are thinking of making changes to [the] Volcker rule, it is because of the substantial changes to the capital framework. It is the expense of the capital that will stop prop trading, not [the] Volcker rule. If there is one rule that has to go, this would be an easy one to go for. If you are a politician, you want to go for things with the smallest downside and the biggest upside in terms of impact," he said.

ASIAN VERSION OF VOLCKER RULE

The Volcker rule has a U.S.-centric view on "too big to fail" and how proprietary trading should be managed. European regulators, on the other hand, took the ringfencing approach to contain problems.

Regulators in Asia have mostly relied on the low level of proprietary trading activity and the requirements for banks to carry high levels of capital as the approach to protect the industry against uncertainty, according to Pogson. But the reduction in proprietary trading in Asia has removed a source of liquidity from the region's bond markets, which have suffered as a result, he said.

A number of regulators in Asia had previously considered introducing their version of Volcker rule, but none has so far pulled the trigger, said Pogson, adding a step away would hopefully bring any thoughts of mirroring it firmly to a close.

THE VOLCKER RULE AND MARKET MAKING

There have also been discussions among market participants in the derivatives world about the need to clarify the Volcker rule and there has been speculation that it might be clarified under the Trump administration.

Andrew Pal, consultant at DerivAsia in Singapore, said the Volcker rule has also raised the question about market making aside from its key remit which was to restrict banks from participating in prop trading.

"Some market participants have argued that [the] Volcker rule is about restricting prop trading but others have argued that it is about restricting client facilitation, which is to make market for clients. We need clarification on [the] Volcker rule to allow banks to do market making," he said.

The Volcker rule needed to be amended to provide clarity to banks that market making should be about client facilitation and not just prop trading, so as to provide banks with comfort, Pal said.

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

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ASIAN FINANCIAL INSTITUTIONS SEEK TO UNDERSTAND MIFID II IMPACT

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

Asian financial institutions are finally waking up to the reality that they could be caught by MiFID II if they offer products and services to clients with a link to the European Union, including executing trades on EU venues.

The EU Markets in Financial Instruments Directive (MiFID II) regulates firms which provide services to clients linked to financial instruments including shares, bonds, units in collective investment schemes and derivatives, and the venues where those instruments are traded.

Keith Pogson, senior partner, financial services at EY in Hong Kong, said MiFID II was mainly about protecting investors, specifically retail investors, while ensuring there was fair play in the market, including best execution, responsible trading activity and avoiding conflicts of interest.

CLIENTS, PRODUCTS, INFRASTRUCTURES

The initial thinking that MiFID II will only affect financial institutions in Europe has proved to be a misconception; its extraterritorial effects will also be felt outside Europe. How MiFID II will affect financial institutions, Pogson said, needs to be examined from three points of nexus: clients, products and infrastructures. For instance, an Asian financial institution with European clients, an Asian financial institution whose Asian clients purchase European financial instruments and an Asian bank which appoints a European broker to execute a trade will all, in some way, be caught by MiFID II.

"Depending on the relationship between the Asian bank and the European broker, the latter may have to go through MiFID II. To the Asian bank, there is direct impact from MiFID II and it has to do with the customer due diligence component, but because it is not directly the market participant, its counterparty, in this case the European broker, will have to have best execution because it is the market participant," he said.

Similarly, when financial instruments such as derivatives or bonds in Asia are settled through a clearing house in Europe, the Asian financial institutions involved in the trade will need to comply with MiFID II because these are considered capital market activities in the euro zone.

Pogson said it is difficult to ascertain at this stage how MiFID II will affect Asian financial institutions given that the legislation is still evolving and the proposed rules continue to change.

"That's a form of frustration for market practitioners. Those who hope that they don't get impacted by MiFID II are hoping that the rules will change or, if not, there's a third route, i.e., taking the smallest impact by trying to stay outside the requirements of MiFID II as much as their business allows," he said.

IMPACT ON ASIAN BANKS

MIFID II will affect both the internal and external processes of Asian financial institutions. Internally, Asian financial institutions will be required to review their processes and fulfil trade reporting obligations. Externally, financial institutions will need to conduct customer due diligence, ensure product suitability and carry out best execution.

The impact of MiFID II on many Asian banks, such as Malaysian or Thai banks, is likely to be minimal compared with the effect it will have on large international financial institutions, Pogson said. Private banking will be the biggest area where Asian banks will be hit by MiFID II, and one of the most challenging areas insofar as dealing with clients is concerned, he said.

For European banks, the effect of MiFID II will be felt largely in the financial markets involving investment banking and derivatives activities, for instance.

DETERMINING THE LEVEL OF PROTECTION

To help them determine the level of protection they need to accord their customers as required by MiFID II, Asian banks will be required to undertake a fair amount of due diligence including evaluating product suitability, Pogson said. But a feature known as "opt up" under MiFID II, which allows banks' customers to become market professionals, i.e., sophisticated investors, may not require banks to carry out the same amount of suitability and due diligence on the customers when executing transactions as they would for retail customers.

Markets such as Singapore and Hong Kong also have their own definitions for sophisticated investors which are accredited investors (AI) and professional investors respectively. Banks in Singapore, for instance, will need to determine whether their AI customers qualify as market professionals under the MiFID II framework. If the AI customers in Singapore choose to opt up under the MiFID II framework, they will be accorded lighter-touch protection, Pogson said.

Likewise banks in Hong Kong will also need to determine whether their customers with professional investor status qualify as market professionals under MiFID II.

"Banks in Asia would need to carry out a gap analysis to determine the work they have to do, the differences in the type of customers and what the gain is," he said.

HOW MIFID II AFFECT ASSET MANAGERS

Asset managers, fund managers and hedge funds will also be affected by MiFID II, but to a lesser extent than banks.

Asset managers will need to work out what is required of them under MiFID II, but are likely to rely on prime brokers and custodians to help them comply with, for example, carrying out trade execution and fulfilling reporting requirements, Pogson said.

"The added burden [of MiFID II] on asset managers is there but not as heavy as that on banks," he said.

Mark Jacobsen, partner at RHTLaw Taylor Wessing in Singapore, pointed to three relationships which he said asset managers in Asia need to appraise when determining how MiFID II will affect them: whether they have subsidiaries/parents, clients, or counterparties in Europe.

"MiFID II is too big to categorise its impact on asset managers in Asia in an easy way. It depends on who you interact with in Europe. Only when you look at those three areas will you be able to determine how you are going to be impacted by MiFID II," he said.

Jacobsen gave different scenarios under which asset managers could be caught by MiFID II. For instance, under MiFID II, asset managers may no longer be allowed to provide research — usually provided by brokers as a bundled service — to clients without the establishment of a separate chargeable account, therefore unbundling the research. In commodity trading, MiFID II requires market participants to trade on platforms that are more transparent, and this is expected to bring a huge change to market infrastructures, Jacobsen said.

MiFID II will also have an indirect impact on asset managers in Asia. For example, when a trade involves clients or counterparties in Europe, asset managers may be obliged to comply with MiFID II because of the contractual relationship between them and their clients or counterparties, Jacobsen said. He gave another example where asset managers providing sub-advisory services to UCITS funds, a mutual fund structure prevalent in the EU, could potentially end up having to comply with certain MiFID II requirements indirectly as a byproduct of their counterparty's regulatory obligations.

FUND MANAGERS AND HEDGE FUNDS

While fund managers operating in markets like Singapore and Hong Kong, particularly those originating from Europe and the United States, are expected to feel the impact of MiFID II, most Asian fund managers, especially those in Southeast Asia, tend to focus on clients and products in their respective domestic markets and so are less likely to be caught by the EU rules.

Hedge funds typically have high investment requirements and this means that all their customers will be considered market professionals under MiFID II, Pogson said. The customer due diligence work required of hedge funds under the MiFID II framework will be relatively lighter.

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

REUTERS/Yuya Shino

MAS' AML FOCUS THIS YEAR: GOVERNANCE, CULTURE AND POLICY IMPLEMENTATION

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

The Monetary Authority of Singapore's anti-money laundering approach this year is expected to focus on governance, culture and policy implementation at financial institutions, said a consultant. This follows a series of enforcement actions last year against financial institutions for AML breaches involving fund flows related to Malaysian sovereign fund 1MDB.

Lem Chin Kok, partner in charge of the financial crime practice at KPMG in Singapore, said he expected to see MAS requiring greater accountability on the part of senior management and the board for money laundering breaches. A culture that puts a strong emphasis on AML will likely be another big focus for MAS, he said.

"MAS will want to see how this strong emphasis on AML is cascaded from the senior management to the first line of defence and being embraced by the entire organisation," he said.

AML policy implementation will likely be the third big focus area, Lem said. The devil however lies in the details. While financial institutions may have the right policy and procedures in place, it was not uncommon that implementation of these AML controls sometimes fell short, he said.

SINGAPORE VERSUS HONG KONG

Some international financial institutions operating in both Singapore and Hong Kong have pointed to the increasingly high AML standards introduced by MAS in recent years, compared to Hong Kong. The withdrawal of banking licenses from Swiss private banks BSI Bank and Falcon Private Bank as a result of AML breaches, and the prosecution of a few former employees of the two Swiss banks, were signs that the MAS' approach toward AML enforcement was likely to intensify, sources said.

A consultant who declined to be named said MAS seemed to be heading toward adopting a tougher stance on AML, in contrast to the Hong Kong Monetary Authority's (HKMA) approach of putting greater emphasis on financial inclusion.

FINANCIAL INCLUSION

In Hong Kong, the HKMA is concerned about the difficulties faced by foreign companies and start-ups looking to open bank accounts and some existing customers of banks who had their accounts closed when they failed to provide the documentation and information banks asked for.

Norman Chan, chief executive of HKMA, in an announcement in September last year which addressed the challenges of pursuing financial inclusion, said it was understandable that global financial institutions have tightened the requirements and put more stringent controls in the account-opening and customer due diligence procedures in recent years. But he also urged banks in Hong Kong to adopt a risk-based approach in account-opening applications and performing CDD on existing customers, rather than adopting a "one-size-fits-all" approach by applying the same standards and requirements to all customers.

HIGHER AML STANDARDS NOT ALWAYS DRIVEN BY MAS

In Singapore, onboarding of new customers now takes longer than in the past due to global regulators' increasingly higher expectations of AML standards, said Lem, but he did not think that MAS' approach toward AML was any tougher than the HKMA. He said the AML requirements under MAS' Notice 626 have remained largely the same for many years, despite amendments made in November 2015 which were mainly to provide clarifications.

"Because MAS is now focusing more on AML, perhaps it gives banks the impression that the requirements have increased. Certainly from MAS' perspective, it is definitely more focused on AML, which was why it set up a dedicated unit in August last year to deal with AML issues," he said.

But it is not just the local requirements which have to be considered. Lem said global financial institutions operating in multiple jurisdictions were sometimes on remedial programmes after having had fines imposed on them, for instance, which may require them to enhance their AML standards. In other instances, the headquarters of some financial institutions have raised their standards for AML controls, which were not necessarily driven by MAS' requirements, he said.

CLIENT ONBOARDING HARDER FOR FOREIGNERS

Some foreign companies in Singapore have also faced difficulties when opening accounts, particularly since last year. Daniel Chia, director at Morgan Lewis Stamford in Singapore, said while foreign companies setting up in Singapore were able to open bank accounts quite easily in the past as they were perceived as Singapore companies, this was no longer the case.

The Accounting and Corporate Regulatory Authority of Singapore (ACRA) is now asking more questions than before, such as how foreign companies looking to set up in Singapore are linked to the city-state, according to Chia.

"Creating local companies [in Singapore] is more difficult now but that is not enshrined in the company law. It's just ACRA asking more questions. Basically, it does not want foreign companies to set up shell companies here," he said.

ULTIMATE BENEFICIARY OWNER

Banks are also more focused on identifying the ultimate beneficiary owners for bank accounts. Chia said banks appeared to be doing more thorough due diligence when the owner of a bank account for a newly set-up company was a foreigner.

"That is a complex process, onboarding is slower and more difficult. Particularly for the less international banks, they don't want to onboard new clients who are foreigners because they don't have the resources and the risk is too high. We have also heard of banks not onboarding U.S. persons because they don't have the resources to do it. The amount of compliance cost to be FATCA-ready is insane. Some banks would rather not onboard new U.S. persons," he said.

There is a discussion that the law should make it mandatory for every company in Singapore to keep a record of ultimate beneficiary owners.

"By doing this, regulators and the police can easily find out who the ultimate beneficiary owner is. This has not yet been implemented as a law. I suspect it will be," Chia said.

MAS SHARES BETTER PRACTICES

The MAS has also been issuing more AML guidance setting out the better practices seen during reviews of other banks, in a bid to raise the standards of the entire industry, said Lem.

"It's a good thing that MAS is sharing the better practices it has seen in other banks so that the industry standards will increase. Some banks have mistaken these better practices as rules they have to follow but they are not rules. How much banks are able to embrace these best practices depends on their size, operations and money laundering risks specific to them," he said.

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

ASIAN REGULATORS URGED TO LEVERAGE FINTECH TO ACHIEVE INTENDED GOALS OF AML REGULATIONS

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

The continuous focus on anti-money laundering (AML) juxtaposed with the rapid development of financial technology has raised the question of how the latter can be best used to achieve the intended purpose of regulations.

Regulators in a number of Asian jurisdictions have continued to update and amend their AML regulations in the last few years to strengthen their regimes. For instance, Singapore has revised its AML rules in the last two years in the run-up to the Financial Action Task Force's (FATF) evaluation in November 2016. Hong Kong, which is preparing for the FATF evaluation next year, has seen its government tighten the AML legislation. The Hong Kong Monetary Authority and the Securities and Futures Commission have also stepped up their focus on AML through the introduction of new guidelines and circulars.

While regulators may be relentless in keeping their AML rules up-to-date, the bigger problem is whether these rules are sufficiently equipped to deal with changes in technology. Financial technology such as anti-money laundering utility models, visual recognition, biometrics, the application of blockchain technology in payment, clearing and settlement, artificial intelligence, robo-advisers, and robotic process automation is changing the financial services landscape.

REUTERS/Thomas Peter

AML REGULATIONS AT DOCUMENT STAGE

But AML regulations remain very much focused on brick and mortar setups and are reliant on documentary evidence whereby banks often require face-to-face verification and physical documents from their customers such as for account opening purposes, said Lem Chin Kok, partner in charge of the financial crime practice at KPMG in Singapore.

Financial technology such as facial recognition, biometrics, GPS, and other ways of customer identification are now available to banks. Such applications may be more effective than relying on physical documents, which will also help banks to better manage risk because of the current technology evolution, Lem said.

"The customer's idea of banking may no longer be brick and mortar. In fact, the way people live has changed drastically since the mobile technology evolution. In that sense, if regulations have not changed much in the last 10 years, what do those regulations mean in today's world where technology is progressing exponentially?" he said.

RULES FOR TODAY'S WORLD

Lem questioned whether AML rules around the world are sufficiently equipped to meet the goals of regulations and to facilitate the pace of development in fintech. Regulators and financial institutions want to embrace technology and are exploring different forms of technology, but the latter face restrictions on their activities if they are bound by the current state of regulations, he said.

"It appears that technology is progressing at a much faster pace than regulation globally. There is an urgent need to explore how new technology can help financial institutions and regulators alike, to better manage financial crime risks." he said.

INCREASED SPENDING ON TECHNOLOGY

In a soon-to-be-published research conducted by EY in 2016, two-thirds of the financial institutions in Asia surveyed, indicated that they expect to spend more this year than before on AML, specifically on know-your-customer processes, with the majority going toward technology.

Liew Nam Soon, managing partner at EY in Singapore, attributed the bigger technology spending to the increasing complexity involved in carrying out KYC; the growing number of transactions involving politically exposed persons (PEPs) and the need to ascertain sources of wealth.

"These are all operational issues. That is why technology is coming in. We are seeing fintech address different parts of the value chain. Some focus on due diligence, others focus reporting, transaction monitoring and alerts. It's not so much because regulators haven't caught up [with regulations]," he said.

OPERATIONAL AND COMPLIANCE COSTS OUT OF CONTROL

AML regulations in jurisdictions, such as Singapore for instance, are already "pretty tight", according to Liew, adding it would be unfair to say that regulations have not evolved in the last 10 to 15 years. He said there have been new discussions on AML regulations in Singapore, referring specifically to the amendments made to MAS Notice 626.

The operational and compliance costs associated with AML are the bigger problem, which Liew said, are out of control. The operations and compliance budgets for AML at many global banks have run into billions of dollars and this is becoming unsustainable, he said.

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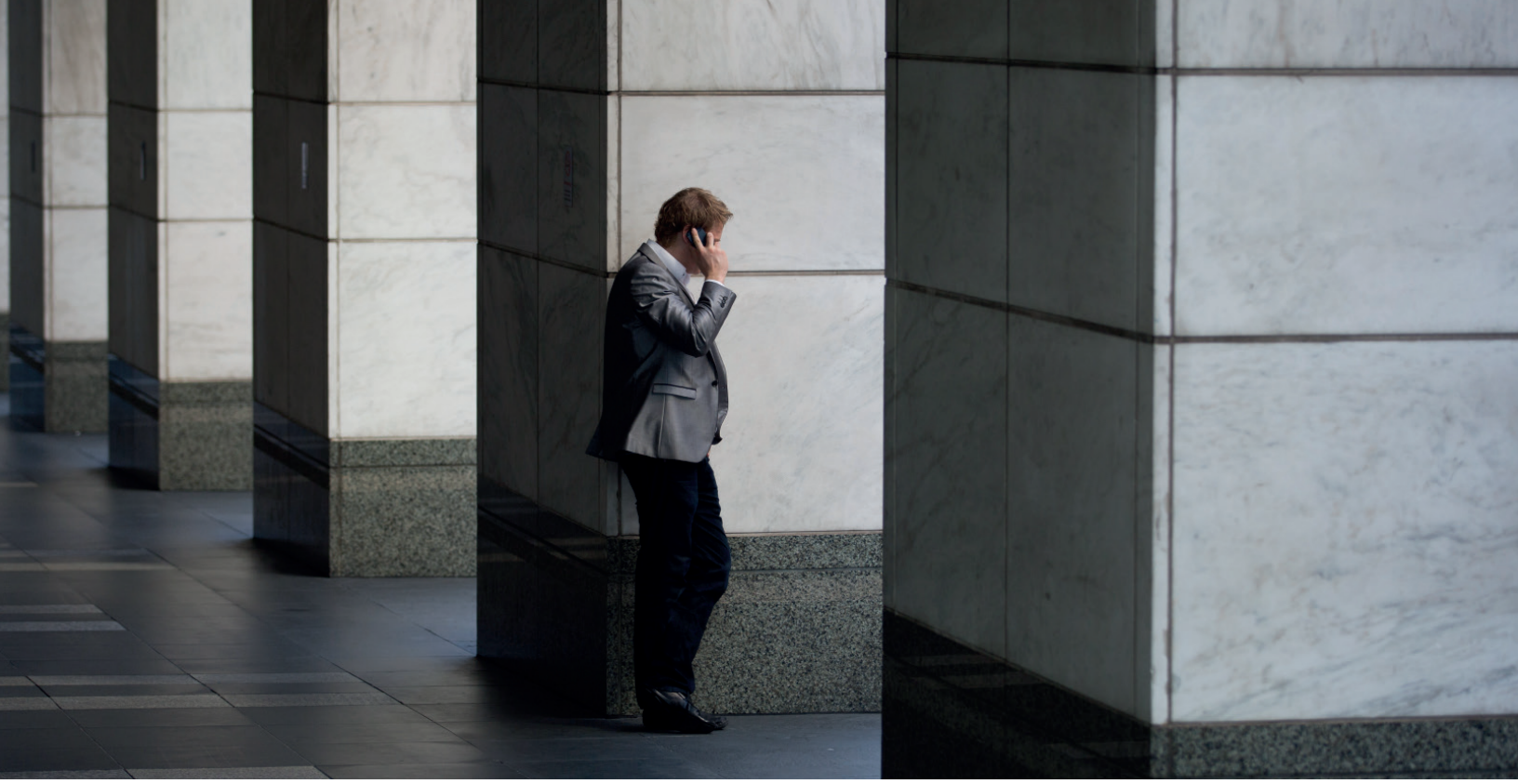

SMARTER FINANCIAL CRIME COMPLIANCE

Philip Rodd, Asia-Pacific Financial Crime Lead, EY

For ASEAN banks, the cost of meeting their KYC and AML requirements with human resources is spiraling out of control. New digital technologies offer banks a lifeline, with the potential to realize sizeable cost savings quickly without the need for significant investment.

In response to ever more digitally sophisticated financial crime threats, regulators around the world are raising the bar on banks' KYC and AML requirements – and handing down record fines for lapses. As part of their financial crime compliance burden, the region's banks are required to:

- Verify a customer's identity on the basis of documents, data or information obtained from a reliable source – and refreshed periodically, potentially every year, depending on the risk profile of the customer
- Identify a business's beneficial owners and verify their identities
- Understand the source of funds that will be placed within the business account
- Investigate the overall source of wealth in the business, which can include the wealth of beneficial owners, even if that money will not be used within the bank account being opened
- Link related accounts across the market segments and jurisdictions in order to have a one- client view of AML risk based on wealth contributors and significant corporate entities

An extraordinary level of human effort is required to meet these demands. In addition to the KYC platform requirements, transaction monitoring can generate more than 1,000 alerts every day for a large bank. If each one of these alerts takes an hour to investigate, a bank will need 133 employees working full-time just to cover this aspect of compliance alone.

The cost is staggering. In 2016, global expenditures on financial crime compliance by top-tier banking and capital markets firms reached a record breaking US$32b – a figure currently projected to rise to US$36.8b by 2018.

This is not just expensive — it's incredibly inefficient. Of the alerts reviewed each day, around 80% are typically quickly found to be benign. The remaining 20% go to the next level of investigation, which takes more time. Of these, another 15–19% are not suspicious. In other words, for every 100 transactions painstakingly investigated by its employees, a bank might file one or two Suspicious Activity Reports (SARs).

No wonder that, in an EY survey of financial institutions in Singapore and Hong Kong last year, 87% of respondents said their AML operations were not cost efficient.

DATA ANALYTICS AND ROBOTICS OFFER CLEAR OPPORTUNITIES TO GET COSTS UNDER CONTROL

anks have many options for improving AML cost efficiency, with most involving technology solutions. The two most common solutions our banking clients are working on are:

- Data analytics – Compliance teams can use advanced data analytics to automatically monitor watch-lists, transactional activity and adverse media screening, enabling firms to proactively identify risks and opportunities. The cumbersome and time-consuming task of transaction monitoring can be also substantially automated by data analytics tools, which can spot false positive AML alerts and monitor scenario thresholds. Analytical tools and visualization software give stakeholders fast insight into what's really going on with a particular account. These tools also automate documentation, encouraging a stronger audit trail.
- Robotics process automation (RPA) – despite its name, RPA is not about deploying robots across an organization, it's simply a type of software used with existing bank technology. The software performs rule-based tasks on a computer, just as a human would, except substantially faster, with 100% accuracy and no breaks. Running in the background, RPA can pull information from multiple bank systems, automating the vast majority of tasks required for initial investigations of transaction monitoring alerts. In addition, RPA is also based on a step-by-step process flow that obtains internal and external publicly available documentation, such as media articles and corporate files, to complete a KYC file, thereby reducing onboarding and periodic review times while enhancing customer experience. RPA utilization can then allow human workers to focus on decision-making, not information gathering – their task reduced to reviewing the findings and making risk-based judgment calls.

HARNESSING ANALYTICS FOR ALERT TRIAGE

By applying advanced analytics to its transaction alert output, for example, a large US institution substantially reduced false positives. The new system analyzed Level 1 alerts for correlations against established true positives, and then escalated any matches. This also cut costs, since the volume of cases escalated for human review and investigation decreased by 46%.

Similarly, in a proof-of-value exercise for a global bank interested in name screening alert triage, we identified the potential for false positives reductions of more than 80% across sanctions and politically exposed persons (PEP) alerts – along with the reduced risk of missed true matches. We calculated that the bank could save up to US$120m over three years, enabling around 800 operational staff to be deployed to higher-value tasks.

USING RPA IN SCREENING INVESTIGATIONS AND KYC

RPA can be easily applied to automate repetitive, clerical processes within a screening function, such as using scripts to automate case dispositioning, based on the decision rules defined by business and operation. Banks can also robotically preprocess negative news searches on Google and collect customer information from external systems to screen individuals and organizations. The software then creates dockets in a standardized format for analysts to review easily and quickly. We have worked with a top-tier bank to implement RPA in the information gathering stage of transaction monitoring alerts, leading to reduction of 70% in the time to process a Level 1 alerts.

RPA can also significantly reduce the time it takes to complete a KYC review, while improving cost - effectiveness. When we helped an international financial institution to remediate a backlog of 9,000 enhanced due diligence cases, our client estimated the remediation required an average of 22 hours per case. The total effort to clear the backlog was around 200,000 hours. Automating just 11 of the 16 process steps with RPA enabled the client to cut the cycle time in half. Even greater improvement is possible through machine learning, artificial intelligence capabilities and optical character recognition technology to read scanned versions of paper-based client files.

CONCLUSION

ASEAN banks need to harness data analytics and RPA in numerous processes within the financial crime control framework, including:

- KYC due diligence and client on-/off-boarding
- AML transaction monitoring alert investigations
- Name screening for sanctions and PEP investigations
- Adverse press investigations
- Payment screening for sanctions investigations
- Source of wealth reviews
- Linking accounts across the institution inclusive of all markets and segments to create a one-client view

The only question is whether they should start with a blend of small incremental steps or large-scale initiatives. Either way, the days of trying to manage AML and KYC compliance efforts with purely human resources are over.

The views reflected in this article are the views of the author and do not necessarily reflect the views of the global EY organization or its member firms.

REUTERS/Ruben Sprich

AML/CTF OUTLOOK: ASIA-PACIFIC REGULATORS TO TARGET TRADE-BASED LAUNDERING IN 2017

Nathan Lynch, Regional Bureau Chief, APAC, Financial Crime & Risk, Thomson Reuters Regulatory Intelligence

Regulators in the major Asia-Pacific financial centres will continue their supervisory focus on trade-based money laundering in the year ahead, officials said. Authorities in Singapore and Hong Kong have signalled their plans to take a harder line on money laundering, terrorist financing and weapons proliferation in 2017. The Australian Transaction Reports and Analysis Centre (AUSTRAC) is also expected to boost its supervisory focus in response to international pressure.

The Financial Action Task Force (FATF) has identified trade-based money laundering as one of the main channels that criminal organisations and terrorist financiers are using to move money throughout the global economy. The problem is widespread across the Asia-Pacific region where there are high levels of manufacturing, established shipping industries and a number of important financial centres.

The AML/CFT regulators in Singapore and Hong Kong have both said confidence in the integrity of their financial centres will be undermined if financial institutions lack effective systems and controls to manage these risks.

To improve compliance in this area the MAS issued guidance for banks on managing trade-based money laundering controls in late 2015. Since then it has been undertaking targeted supervision work focusing on trade-based laundering compliance. The Hong Kong Association of Banks (HKAB) followed suit with similar guidance in February last year, with input from the Hong Kong Monetary Authority (HKMA).

Both of the guidance papers said banks need to establish effective AML/CFT risk management systems and controls to offset the financial crime risks arising from trade financing. They also need to have controls in place to manage the risks associated with financing dual-use goods, which can be used in weapons manufacturing.

Australia has been watching these developments closely and is also taking steps to encourage reporting entities to manage the risks associated with trade-based laundering.

Bradley Brown, AUSTRAC's national manager for strategic intelligence and policy, said the agency and its law enforcement partners had repeatedly highlighted trade-based money laundering as a critical risk for Australia.

Brown told Thomson Reuters Regulatory Intelligence that managing the risks associated with trade-based money laundering would require continuous investigation and due diligence from reporting entities.

"The over, under or false invoicing of goods for import and export can have significant implications on Australia's revenue collection and facilitate transnational organised crime," Brown said.

AUSTRAC is also providing financial intelligence support the Australian Federal Police, the Australian Border Force, the Australian Criminal Intelligence Commission, the Australian Taxation Office and other partner agencies.

"A major example has been AUSTRAC's work within the ACIC Taskforce Eligo, which has focused on Australian and international networks involved in money laundering through various means, including trade-based money laundering," Brown said.

LEADING THE CHARGE

Singapore and Hong Kong are still leading the charge when it comes to trade-based money laundering. The MAS has made it clear it intends to take a harder line on AML/CFT supervision and enforcement in coming years. The recent closure of BSI Bank in Singapore was an example of its heightened focus on regulatory compliance.

The MAS also set up a dedicated AML enforcement department in June last year to tackle this issue, among others.

"For Singapore to maintain her reputation as a clean and trusted commercial, trading and transportation hub, banks must ensure that their AML/CFT controls remain effective and are commensurate with the size, nature and complexity of their business," the MAS said in its guidance on trade-based laundering.

"It is imperative that senior management set the right tone at the top and inculcate an appropriate risk and compliance culture among its staff, across all levels and functions, to ensure effective implementation of a strong AML/CFT framework."

RISK ASSESSMENTS

Regulators have said risk assessments targeting trade financing risks can be conducted as part of the broader risk assessments that banks perform. These assessments should identify any risk areas in their trade finance activities and determine whether the controls are adequate.

In addition to the standard customer due diligence obligations, banks are expected to obtain further information to assess the financial crime risks specific to a trade finance transaction. This enhanced due diligence should cover all of the parties to a transaction, including the beneficiaries of letters of credit and documentary collections, agents and third parties.

The MAS said last year, when establishing the new enforcement team, that the increasing complexity of trade and finance meant there was a need for more targeted supervision and enforcement work. The MAS's AML/CTF enforcement team is understood to have more than 30 dedicated staff.

The Financial Action Task Force's (FATF) recent mutual evaluation said that trade-based laundering was an "emerging threat" in Australia. In addition to AUSTRAC's work, the Australian customs service has established a trade enforcement unit to target trade-based laundering in the region.

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

MAS' DATA ANALYTICS INITIATIVE RAISES CONCERNS ABOUT POTENTIAL INCREASE IN REGULATORY BURDEN

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

Banks in Singapore have expressed concerns that the Monetary Authority of Singapore's latest initiative in setting up a new Data Analytics Group may eventually lead to an increase in regulatory burden, contrary to experts' views earlier.

MAS is clearly ahead of most regulators in setting up the new Data Analytics Group (DAG) as part of its efforts in increasing supervision of financial institutions. The latest initiative came at a time when anecdotal evidence from the financial services sector in the city-state revealed that MAS has recently asked some banks for details about things they reported a long time ago, in some cases, as long as five years.

Sources said this might be an attempt by the Singapore regulator to carry out a big clean-up, but others said there may be no specific reason at all.

REGULATORS WANT TO SEE BANKS' ABILITY TO EXTRACT AND AGGREGATE DATA

Simon Topping, head of regulatory practice at KPMG China, said he recalled asking the Bank of England why regulators were increasingly asking banks for more information compared to the past. The Bank of England's response, he said, might shed some light.

"The response from the Bank of England was that it wanted to see whether banks are able to provide the data. Regulators feel that banks' systems should be flexible enough to generate data whenever regulators ask for it," he said.

Given that no regulators can really foresee the future, it is to the industry's advantage if banks are able to demonstrate the flexibility and ability to extract and aggregate information, Topping said. MAS' newly set up Data Analytics Group seeks to help the regulator understand risk and to spot the next big potential problem that may emerge in the years to come, he said.

In general, regulators do two things with the data they collect from banks. They add up the data and they look for outliers.

"If you have a number of banks reporting the same information, they will see which one has the biggest number. It's just applying analytics to data – regulators do correlation, trend analysis and stress testing. It's good that MAS is having a group of people to do it. They are trying to see what insights they can get by playing around with data," Topping said.

Data also provides new insights about the industry. Some of the insights regulators can obtain by applying analytics on data include trends in the market regulators should watch out for, emerging risk, and the data series which are early worrying indicators of future problems.

EARLY DAYS

Some consultants believe that MAS has not specified the kind of data it requires from banks as the Data Analytics Group is in the process of identifying the data it needs.

"It is premature to say whether banks have to do more work [following the establishment of the DAG at MAS]. Banks shouldn't be overly worried. Banks have the data anyway. If they have clear data, they don't have to do anything. In effect, nothing has changed," said Vincent Loy, Asia-Pacific financial crime and cyber leader at PwC in Singapore.

Loy said while banks' concerns were valid, it is advisable for banks to engage with MAS as early as possible, which will help them to understand its data requirements.

SYSTEM INCONSISTENCY

One of the challenges faced by financial institutions is when the data systems at banks are inconsistent or incompatible with one another, and this happens when banks acquire new businesses over the years which could result in system inconsistency or some systems not properly reconciled, Loy said.

"It's about how the IT systems at banks are created. Historically, banks' architecture has been a series of mergers and acquisitions and this is true especially of the global banks. Traditionally banks have been quite bad when adding new systems or reconciling the systems to make sure they are linked or talk to one another," he said.

The smaller banks, which have not gone through as many mergers and acquisitions, are likely to have a "cleaner" data system compared to the larger banks. They are likely to have problems in generating data only if most of their processes are done manually or if they have not invested sufficiently in technology, Loy said.

"The onus is now on banks to ensure whatever data they provide to MAS is accurate and correct," he said.

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

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A member of the EY global regulatory compliance network, Phil is focused on monitoring and assessing regulatory change and advising clients on the impact. He has provided regulatory compliance advisory services to financial institutions including AML, suitability, sales practices, preparation for regulatory inspections, review and testing of the effectiveness of improvement plans and third party reviews on behalf of regulators.

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