Being better informed

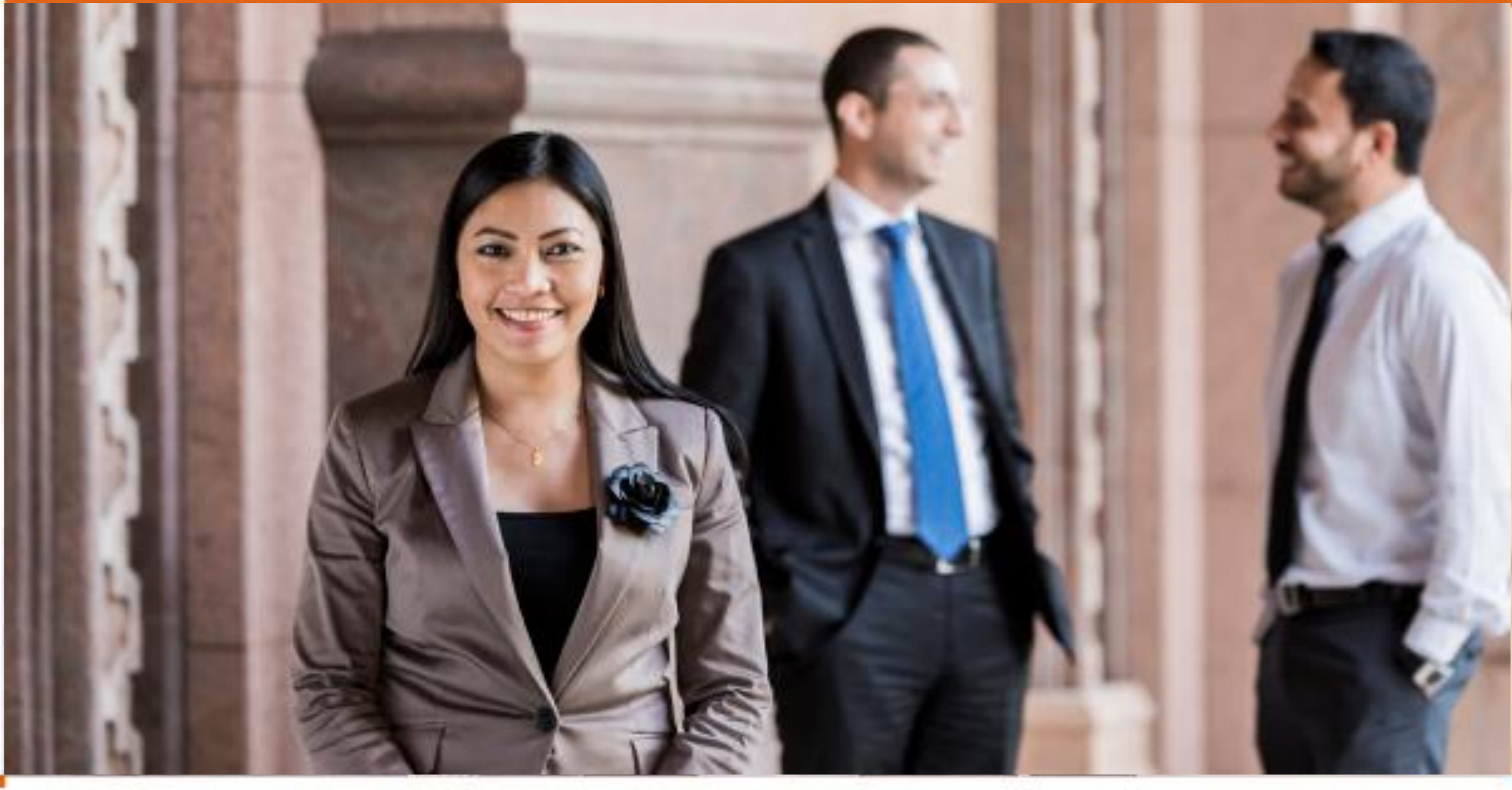
FS regulatory, accounting and audit bulletin

PwC FS Regulation

Q1 2015

In this quarter's edition:

- Oman publishes D-SIB framework
- DFSA changes client agreements
- Basel delays derivative margin requirements



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Executive summary

Welcome to this edition of "Being better informed", our quarterly FS regulatory, accounting and audit bulletin, which aims to keep you up to speed with significant developments and their implications across all the financial services sectors.

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One would think that the pace of change in the regulatory requirements within financial services has slowed down. However, if one were to stand back and see the cumulative effect of all that has arrived and that which is imminent, it is apparent regulation and compliance will continue to be on top of Board and senior management's agendas.

Within the region, one key announcement which was noteworthy was the issuance of the prudential regulations for insurance companies licensed in the UAE. Separate set of rules were issued for conventional insurance and reinsurance and for Takaful/retakaful. This has been the single most transformational regulatory instrument issued by the UAE Insurance Authority since it was established in 2007 under a new law at that time. We will cover these new rules in more detail in a feature in our next edition.

The Central Bank of Oman issued its Domestic Systemically Important Bank (DSIBs) rules. A key implication among all other important qualitative changes to governance and operations is the need to hold additional 1% capital. This brings yet another Middle Eastern and GCC country in line with Basel standards with regards to DSIBs. Our earlier editions noted that Qatar and Bahrain had earlier issued rules and asked for submissions of recovery and resolution (Bahrain) and recovery and capital (Qatar) plans.

IMF continues to monitor developments around Islamic finance - a research paper focussed on whether Islamic finance increases financial inclusion. I suppose it, no doubt, attempts to woo individuals who remained outside the perimeter of the financial system. However, my reading of the paper indicates that there is weak evidence to suggest that is indeed the case. Incidentally, yet another paper found that stress on Islamic bank deposits were less pronounced during the crisis. Both carry interesting perspectives.

The DFSA issued its paper on how it functions, in the interests of transparency and revealed its focus on risk-based supervision of firms. In particular, firms should take note of the hardened approach to their resources, systems and controls.

When we look at work outside of the Middle East, Basel Committee's Work Programme for 2015 and 2016 is something that is useful to those wanting to understand what's imminent in so far as banks are concerned. Clearly, it appears there is going to be some rationalization and perhaps fewer surprises. For example, Basel's release of a consultation paper on Standardized Approach has come as a welcome surprise as it is evident that the standard setters have gone back to the drawing board having recognized the many flaws of a framework designed to quantify risks that are not so easily quantifiable.

The newsletter also discusses a number of other developments. Mark Carney's remark in the FSB's note to the G20 discussed in this edition about focus areas and some potential risks are noteworthy. The Joint Forum's work around credit risk provides some pointers to the regulators in terms of potential concerns. IOSCO's last report on international comparisons for capital concludes there will no longer be such effort due to principal differences in computations and models for the same among other reasons.

Your feedback is important to us so we can continue to make this bulletin more meaningful to its readers.

How to read this bulletin?

Review the Table of Contents and relevant Sector sections to identify the news of interest. We recommend you go directly to the topic/article of interest by clicking in the *active links* within the table of contents.

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Middle East announcements

Capital and liquidity

D-SIBs to hold 1% surcharge

The CBO issued its *framework for identifying D-SIBs* on 28 January 2015, requiring D-SIBs to hold an additional 1% capital against RWAs. The CBO plans to enhance its supervision of D-SIBs to reduce probability of their failure by holding them to specific requirements.

The CBO's new framework mandates that D-SIBs perform rigorous stress testing exercises, embed well-defined early warning and crisis management mechanisms, build a robust recovery and resolution plan, a comprehensive risk appetite framework, and develop a vision statement with appropriate strategies to address their systemic risks.

The D-SIB will need to prepare the suggested stipulations within one month of being designated as a D-SIB so as to be able to complete the process within a year thereafter.

Consumer protection

DFSA changes client agreements

The DFSA updated the *conduct of business module of it rulebook* on 11 February 2015. It changed the way firms must recognise client agreements from 1 April 2015. It added new requirements for firms when relying on a client agreement made by a third party. It also made some minor amendments to the glossary module and the collective investment rules to reflect this change.

Islamic banking

Are Islamic banks inclusive?

The IMF issued on 13 February 2015 a research paper asking *"Can Islamic Banking Increase Financial Inclusion?"*. It analyses the relationship between the development of Islamic banking and financial inclusion. In the countries of the OIC various indicators of financial inclusion tend to be lower, and the share of excluded individuals citing religious reasons for not using bank accounts is noticeably greater than in other countries; Islamic banking would therefore seem to be an effective avenue for financial inclusion.

But the IMF found that although physical access to financial services has grown more rapidly in the OIC countries, the use of these services has not increased as quickly. Its analysis showed weak but positive link from credit to households and firms to financing investment, but this empirical link remains tentative and relatively weak.

The paper explores reasons why this might be the case and suggests several recommendations to enhance the ability of Islamic banking to promote financial inclusion, including changes to the operating model of Islamic banks by creating separate SME business units, improving the training of personnel in Sharia'ah-compliant instruments, developing Islamic microfinance, establishing Islamic equity funds for SMEs, improving the quality of credit information and enhancing the efficiency of the legal system.

Are Islamic banks safer?

The IMF found that Islamic bank branches are less prone to deposit withdrawals during financial panics in a *research paper* issued 26 February 2015. Contrasting countries where Islamic and conventional banks co-exist, it compared these banks during a financial panic and found Islamic bank branches are less prone to deposit withdrawals during financial panics.

On top of this the IMF found the Islamic branches of banks with both Islamic and conventional operations tend to attract (rather than lose) deposits during panics, which suggests a role for religious branding. It also found Islamic bank branches grant more loans during financial panics and that their lending decisions are less sensitive to changes in deposits. The IMF concluded that greater financial inclusion of faith-based groups may enhance the stability of the banking system.

Supervision

DFSA updates policy and processes module

The DFSA issued the *"February 2015" Edition of the Regulatory Policy and Process ("RPP") Module* on 12 February 2015. It provides an understanding of how the DFSA functions and operates and its expectations from the regulated community.

The DFSA outlines its risk-based approach to supervision, and describes what this involves, including the risk management cycle, need for relationship management, the notification regime, the use of supervisory tools, and consideration to consolidated supervision by other competent authorities.

The DFSA has hardened its stance on Resources, Systems and Controls, replacing the word “may” to “will” in its stance on sufficient resources: “the DFSA will have regard to whether an Authorised Person has sufficient resources”. This includes resources such as financial, human, operational, and control systems.

In the newly added chapters to the RPP the DFSA describe how it protects, uses and discloses confidential information received through its role as a regulator. It describes its approach to handling applications for waivers and modifications from one or more Rules of the DFSA Rulebook or Articles of the Markets Law 2012.

This new edition of the DFSA Sourcebook replaces the "November 2014 Edition" which is no longer in effect.

QFCRA makes minor rule changes

The QFCRA consulted on minor rule changes in *Consultation 2015/01* on 20 March 2015. It proposes a number of minor amendments to various Regulatory Authority rulebooks. It regularly undertakes miscellaneous amendments to its legislative framework that:

- addresses specific policy issues that have arisen in the application of the rules
- improves the consistency across the Regulatory Authority rulebooks.

The QFCRA proposed amendments are relevant to all authorised firms but it believes they are minor in nature and will not have a significant impact on firms.

In 2014 the QFCRA changed the reporting currency used in the Banking Business Prudential Rules and the Investment Management and Advisory Rules from US dollars to Qatari Riyals and rounded as appropriate. For consistency it has proposed that the currency used in all other rules be amended to convert the stated currency from US dollars to Qatari Riyals.

The QFCRA also proposed firms’ money laundering reporting officer report to the regulator every 31 December and that firms provide a copy of his report along with written confirmation from the firm’s senior management that they have considered the report and approved any required action plan.

The consultation closes **20 April 2015**.

International announcements

Capital and liquidity

Basel Committee monitor implementation

On 3 March 2015 the Basel Committee published the results of its latest *Basel III monitoring exercise* as part of its periodic review of Basel III implementation. It studied 98 of the world's largest banks and 126 smaller banks. It found that all banks studied now meet the Basel III risk based capital minimums. The average CET1 ratio of the largest banks was over 10% and nearly 12% for the smaller ones. Nearly all the sample d banks met the required LCR and NSFR ratios too.

IOSCO and Basel delay margin requirements

IOSCO and the Basel Committee announced a *nine-month delay to the implementation margin requirements for non-centrally cleared derivative contracts* on 18 March 2015. This delay pushes back the new margin requirements from 1 December 2015 to 1 September 2016. The Basel Committee and IOSCO stated that they are working with the industry, in particular ISDA, to agree new margin calculation models that will comply with the BCBS/IOSCO principles.

Basel Committee revises Pillar 3

The Basel Committee published *Revised Pillar 3 disclosure requirements* on 28 January 2015. The most significant changes relate to the use of templates for quantitative disclosure. The Basel Committee wants to enhance comparability of bank's disclosures, both between banks and over time for an individual bank. It also focuses on improving the transparency of internal model based approaches that banks use to calculate minimum regulatory capital requirements.

Firms will have to disclosure and attest that disclosures have been prepared in accordance with board-agreed internal control processes. The revised requirements take effect from end-2016.

Basel consults on expected credit losses

The Basel Committee consulted on *guidance on accounting for expected credit losses* on 2 February 2015. It outlined 11 fundamental principles, eight for banks and three for supervisors, and detailed sound credit risk practices for banks when implementing and applying an expected credit loss accounting framework. The Basel Committee expects practices to include validation of credit risk assessment models and public disclosure. It addresses how supervisory expectations of an expected credit loss framework should interact with a bank's overall credit risk practices and the regulatory framework.

The Basel Committee is replacing the 2006 *guidance on Sound Credit Risk Assessment and Valuation for Loans* which was based on the incurred-loss model of accounting. The consultation closes on **30 April 2015.**

Restoring confidence in capital

The Basel Committee published its *Work Programme for 2015 and 2016* on 21 January 2015. Much of its work will be geared towards reviewing existing methods of measuring risk-weighted assets. It will consider the use of simple, transparent and comparable criteria for securitisations, the fundamental review of the trading book and interest rate, credit and operational risk in the banking book.

The Basel Committee also plans new initiatives to:

- review the regulatory treatment of sovereign risk
- assess the interaction, coherence and overall calibration of the reform policies
- assess the role of stress testing in the regulatory framework in light of national developments.

The Basel Committee will continue to monitor its members' implementation of the Basel framework via the Regulatory Consistency Assessment Programme (RCAP). This year the RCAP will be expanded to also cover liquidity standards and the frameworks for G-SIBs and D-SIBs.

IOSCO compares prudential regimes

IOSCO published its final *findings and analysis of prudential standards in the securities sector* on 24 February 2015. It highlights similarities, differences and gaps among the different international frameworks for securities commissions with a view to updating its 1989 report on *Capital Adequacy Standards for Securities Firms* in light of the identified issues.

In 2014 IOSCO *consulted* on two regulatory and supervisory areas that might be considered in an update of its 1989 report: regulatory arbitrage opportunities created by differences across jurisdictions, and the use of internal risk models that may leave the system undercapitalised.

IOSCO concluded that it was not possible to determine whether the capital requirements in one jurisdiction are more onerous than another, chiefly because supervisory discretion and the use of internal models makes numerical comparisons misleading. But if felt it did not need to make any further amendments to the 2014 or 1989 reports because it felt that overall prudential standards were sufficient to address its concerns.

Improving credit risk management

The Basel Committee, IAIS and IOSCO jointly *recommended developments in credit risk management across sectors* on 5 February 2015. A combined committee of the three standard setters, known as the Joint Forum, surveyed supervisors and firms in the banking, securities and insurance sectors to understand how the approach to credit risk management has changed since the financial crisis of 2008.

Firms have improved their management of credit risk in governance and risk reporting. But some supervisors cautioned that some credit risk management and regulatory capital models could mask increased risk-taking, so the Joint Forum cautioned against over-reliance on internal models. As firms hunt for yield in the low interest rate environment, firms increased their risk tolerance in a variety of products. So the Joint Forum recommended supervisors monitor the potential increase of these risk-taking behaviours.

The Joint Forum found OTC derivatives to be a significant source of credit risk. It recommended that supervisors be aware of the growing need for collateral to meet margin requirements for OTC derivatives, and committed the Basel Committee, IAIS and IOSCO to monitor collateral availability in their future work. As the increase in central clearing of OTC derivatives has concentrated credit risk into CCPs, supervisors must consider whether firms are accurately capturing CCP exposures as part of their credit risk management.

The consultation closed for comments 4 March 2015.

Banks struggle with risk management principles

The Basel Committee published its second report on *Progress in adopting the principles for effective risk data aggregation and risk reporting ("Principles")* on 23 January 2015. The 2013 Principles strengthen risk data aggregation and risk reporting at banks to improve risk management practices and decision-making processes. Firms designated as G-SIB are required to implement the Principles in full by 2016.

The Basel Committee outlines the measures G-SIBs took to improve their overall preparedness for compliance with the Principles during 2014. While G-SIBs are increasingly aware of the importance of implementing the Principles, 14 of the 31 participating banks reported that they will be unable to fully comply by the 2016 deadline, compared with 10 G-SIBs in 2013.

IOSCO can't compare jurisdictions

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Basel III FAQs

On 11 March 2015, the Basel Committee published an *updated list of FAQs* for banks participating in the Basel III monitoring exercise.

A sample of banks complete a questionnaire on the impact of Basel III and submit it to the Basel Committee twice a year. The FAQ document lists those questions that banks most frequently raise when completing the questionnaire. The questions cover the full range of Basel III initiatives but there is a particularly high volume of questions and answers on liquidity and the NSFR.

Credit rating agencies

IOSCO amends CRA code of conduct

On 24 March 2015, IOSCO published *amendments* to its CRA code of conduct. IOSCO aims to:

- ensure CRAs are independent and avoid conflicts of interest
- improve the transparency and timeliness of credit ratings disclosures
- improve communication with market participants
- strengthen treatment of confidential information.

The amendments support the wider international push to hold CRAs to a level of accountability commensurate with their role in the financial system. CRAs have widely adopted previous versions of the code of conduct and we expect them to adopt this updated version in due course.

Financial stability

FSB highlights priorities

FSB Chairman Mark Carney wrote to the G20 on *Financial Reforms – Finishing the Post-Crisis Agenda and Moving Forward* on 4 February 2015. He identified the FSB's priorities as full, consistent and prompt implementation of agreed reforms, and finalising the design of remaining post-crisis reforms. He wants the G20 to focus on three particular reforms in particular:

- completing banks' new capital framework
- ending too-big-to-fail
- making derivatives markets safer.

Carney considers the main risks to the global economy to be market based finance and conduct risk.

Setting G20's priorities

On 11 February 2015, the G20 published a *communiqué* following the meeting of finance ministers and central bank governors in Istanbul on 9 and 10 February 2015. It outlined a regulatory action plan for the next 12 months which includes:

- agreeing the TLAC ratio for G-SIBs
- implementing effective resolution regimes for all systemic parts of the financial sector
- agreeing the methodology for identifying systemically important financial institutions beyond the banking and insurance sector
- enhancing cross-border cooperation of resolution and OTC derivatives market reforms.

The G20 also agreed to implement the updated shadow banking roadmap agreed in Brisbane last year, intended to improve global oversight and regulation of shadow banking.

Significant non-bank non-insurers

On 4 March 2015 the FSB and IOSCO published a second public *consultation* on its assessment methodology for identifying global systemically important financial institutions that are neither banks nor insurers (NBNI G-SIFIs). As most of the original responses highlighted disagreements around assessing asset management systemic risk, the revised guidelines present separate methodologies for investment funds and asset managers. Upon receipt of responses, the FSB and IOSCO look to finalise the methodologies by the end of 2015.

The proposed methodologies seek to identify NBNI financial entities whose distress or disorderly failure, because of their size, complexity and market interconnectedness, could lead to larger financial instability. Because most NBNIs are primarily regulated from a conduct, as opposed to prudential, perspective, IOSCO and FSB hope that a universally accepted set of methodological principles can help address some of the data and information gaps that currently exist around systemic risk.

The process of identifying NBNI G-SIFIs requires looking at different types of entities from different industries with differing legal forms, business models and risk dynamics, and so the proposed methodology combines cross-sector risk factors along with sector-specific criteria. The basic set of impact factors include: size, interconnectedness, substitutability, complexity and cross-jurisdictional activities. Leverage is now a bigger consideration for determining whether investment funds meet the size criteria thresholds.

As the proposed methodologies will not only inform international data gathering and systemic risk monitoring, but will also potentially shape national initiatives to apply prudential regulation to NBNI financial entities, firms should carefully assess whether they could potentially be labelled as systemically important under the proposed methodology.

Securities and derivatives

IOSCO promotes derivative certainty

IOSCO outlined nine standards to reduce uncertainties in derivatives markets in its final report on *Risk Mitigation Standards for Non-centrally Cleared OTC Derivatives* on 28 January 2015. It published these to support the *capital requirements for non-centrally cleared OTC derivatives* published jointly with the Basel Committee in 2013.

IOSCO's recommendations cover all major players in the non-centrally cleared OTC derivatives market. Financial entities and systemically important non-financial entities that use non-centrally cleared OTC derivatives should employ the risk mitigation techniques IOSCO recommends. It proposes these firms establish policies and procedures to:

- document the trading relationship with their counterparties before executing a non-centrally cleared OTC derivatives transaction, including all material terms governing the relationship
- ensure the material terms of all non-centrally cleared OTC derivatives transactions are confirmed as soon as practical
- reconcile with counterparties the material terms and valuations of all transactions in a non-centrally cleared OTC derivatives portfolio
- regularly assess and engage in portfolio compression.

Firms must agree and document the process for determining the value of each transaction at any time, and the process for determining when discrepancies in material terms or valuations should be considered disputes. IOSCO wants regulatory authorities to collaborate to minimise inconsistencies in risk mitigation requirements across jurisdictions, and to implement the standards as soon as possible.

Bilateral margin delayed until 2016

BCBS and IOSCO announced a nine month delay to the globally agreed implementation date for non-centrally cleared margin when they published the amended *Margin Requirements for Non-centrally Cleared Derivatives* on 18 March 2015. The new schedule delays implementation of both initial margin (IM) and variation margin (VM) requirements from 1 December 2015 to 1 September 2016. The full phase-in schedule for IM has been adjusted accordingly in the BCBS/IOSCO margin standards.

BCBS and IOSCO state that they are working with the industry to agree new IM calculation models that will comply with the BCBS/IOSCO principles. EU rule makers are expected to amend the draft EMIR rules for non-centrally cleared margin to align them to the international schedule.

LEI goes online

On 26 January 2015 the Global Legal Entity Identifier Foundation (GLEIF) launched its new *website* in a further step to make LEI information available. The GLEIF, established by the FSB in 2014, manages the worldwide development of LEIs.

The site enables communication with the GLEIF and sets out instructions for obtaining an LEI from local operating units. In late 2015 the GLEIF expects the website functionality will allow LEI participants to access to the database of all LEIs issued globally and their associated reference data.

CCPs get stress tested

On 11 March 2015, IOSCO and the Committee on Payments and Market Infrastructures *announced* that they will be stress testing CCPs. Noting the important role CCPs play in the global financial system, IOSCO and the CPMI plan to check that CCPs have the financial resources to manage both credit and liquidity risk, which entails incorporating a number of extreme but plausible scenarios.

Results of the stress tests are expected later in 2015.

FSB wants FX progress report

In his capacity as FSB Chair, Mark Carney *wrote* to the Chairman of the London Foreign Exchange Joint Standing Committee on 20 March 2015.

Carney requested the Committee's support in reporting on market participant's progress in implementing the FSB's recommendations on FX benchmarks, published on 30 September 2014. The Committee must report on the status of its members as at 30 June 2015, and provide this report to the FSB no later than 31 July 2015.

Accounting

Financial accounting

Consolidated financial statements Q&As

IFRS 10 'Consolidated financial statements' and IFRS 12 'Disclosure of interests in other entities' were issued in May 2011. IFRS 10 retains the key principle of IAS 27 and SIC 12: all entities that are controlled by a parent are consolidated. But some of the detailed guidance is new and may result in changes in the scope of consolidation for some parent companies. Experience suggests that the new requirements will have the greatest impact on consolidation decisions for structured entities (i.e. SPVs) and for pooled funds managed by a third party.

Our *In depth publication IFRS 10 and 12 - Questions and answers* sets out our views on some of the most common issues that arise during the implementation of the new standards. For further guidance on IFRS 10, see our *'Practical guide to IFRS: Consolidated financial statements – redefining control'* and *the supplement for the asset management industry*.

Hedging in practice

Many companies are now considering IFRS 9, the new accounting standard on financial instruments. IFRS 9 addresses all the relevant aspects on the accounting for financial instruments, including classification and measurement, impairment of financial assets and general hedge accounting.

Our *publication 'IFRS 9 Hedging in Practice - Frequently asked questions'* presents a number of frequently asked questions and focuses on just one topic in IFRS 9: general hedge accounting.

IASB Investor Update - January 2015

IASB Investor Update - Our newsletter for the investment community - January 2015 includes discussion of judgements and estimates in revenue recognition.

IFRS for SMEs - January 2015

Our *January update on IFRS for SMEs* includes the following discussions:

- IASB meetings on the comprehensive review of the IFRS for SMEs
- adopting the IFRS for SMEs in Uruguay
- upcoming 'train the trainers' workshops
- IFRS for SMEs translations: status report
- where to obtain IFRS for SMEs materials.

Expected credit loss disclosures

IFRS 9 introduces significant additional disclosure requirements relating to credit risk and expected credit loss allowances. Understanding the data and systems needed to meet these new requirements will be critical to ensuring the completeness of IFRS 9 project scopes, thereby avoiding revisions later in the project that could be costly and jeopardise project timings. Simply replicating the illustrative disclosures included in IFRS 9 risks missing key information requirements.

Considering these disclosure requirements as part of the broader consideration of internal management reporting and investor communications will also likely deliver significant benefits. Our *In depth publication 'IFRS 9: Expected credit loss disclosures for banking'* sets out key considerations and what they will mean in practice.

Changes to revenue standard

The FASB and IASB discussed several implementation issues related to the new revenue standard at their February meeting. The boards were aligned on the need to address stakeholder feedback on licenses and performance obligations, but did not agree on the approach to do so. The FASB decided to amend the principle related to licenses, whereas the IASB decided to simply clarify it. The FASB also intends to make several changes to the guidance for determining performance obligations. The IASB will instead explore adding additional examples to illustrate the principle of *"distinct in the context of the contract"*.

Our publication *In transition 'The latest of revenue recognition implementation'* provides an overview of the implementation issues discussed.

IFRS 13 disclosures

IFRS 13 expanded the guidance on assessing fair value measurements within the three levels of the fair value hierarchy. As a result, the classification as Level 1, Level 2 or Level 3 became required for non-financial assets and liabilities measured at fair value and disclosures of fair values in the notes to the financial statements. Experience suggests that challenges arise in practice when determining where measurements fall within the fair value hierarchy.

In depth 'A look at current financial reporting issues - IFRS 13 disclosure requirements – Questions and answers' sets out our views on some of the key considerations in determining the appropriate classification of fair value measurements, such as:

- the meaning of observable and unobservable inputs;

- key differences between Level 1 and Level 2 inputs; and
- when an unobservable input is significant enough to make the whole fair value measurement Level 3.

Leases project update

The IASB staff published a short *Project Update: Definition of a Lease* on 24 February 2015. This document explains how a lease would be defined in the new Leases Standard based on the IASB's decisions in redeliberations.

Is this Basel IV?

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In 2014 the BCBS consulted on five revisions to Pillar 1 of the Basel III framework, three of which closed in Q1 2015. Clearly the standardised approach to measuring risk was in BCBS' sights as it consulted on revisions to credit, counterparty credit, and operational risk. This is in addition to its consultation on standardised capital floors and the fundamental review of the trading book. Each consultation is significant in its own right, but considered as a whole, they represent a substantial revision to the regulatory capital framework. It appears as if the Committee is already working on replacing today's Basel III implementation projects with tomorrow's regulation. I see these consultations as setting the foundations for Basel IV below I summarise each of the proposals and offers initial thoughts on the consequences.

BCBS overhauls credit risk requirements

BCBS proposed revising the *Credit Risk Standardised Approach* on 22 December 2014. The proposals are wide ranging and may require banks to hold more capital. BCBS wants to reduce the role of credit rating agencies (CRAs) in determining capital requirements, instead requiring banks to examine their counterparty's financial circumstances to determine the riskiness of exposures themselves.

For interbank exposures, BCBS proposes forbidding banks from basing their risk-weights on CRA ratings, suggesting they consider the counterparty's capital adequacy and asset quality. Similarly for corporate exposures it proposes forbidding banks from basing their risk-weights on CRA ratings, suggesting they consider the corporate entity's revenue and leverage. It also proposes:

- tightening the criteria for banks to apply a 75% risk-weight to retail exposures
- abolishing the 35% risk-weight for residential mortgages, replacing it with a risk-weight proportionate to the original loan-to-value ratio and the borrower's loan-to-income ratio
- two new options for commercial mortgage risk-weighting
- reducing the number of approaches to credit risk mitigation, including updating the corporate guarantor eligibility criteria.

The credit risk of exposures to sovereigns, central banks and public sector entities is excluded from the revisions as it will be the subject of a separate consultation. BCBS is likely to do away with the 0% risk-weight under the standardised approach.

The proposed method for calculating interbank exposure risk-weighted assets (RWAs) could increase procyclicality. For example, banks X and Y are exposed to bank Z. A decrease in bank Z's capital ratio would increase the RWAs of bank X and Y, thereby reducing their capital ratios. If bank Z is exposed to X or Y it will experience another decrease in its capital ratio. Currently, a CRA will consider a bank's capital position in its credit assessment as one of many inputs. The proposals remove these additional inputs which makes the link between bank X, Y, and Z's capital positions more direct and accentuated. Increased cyclicality of credit risk has the potential to create systemic financial instability which opposes BCBS' core intentions.

Under the proposals, banks will need to use revenue and leverage to determine the risk weight for exposures to corporates and capital adequacy for other financial institutions. For unrated corporates and institutions this will add a welcome measure of risk sensitivity. But for those with a CRA rating the proposals could remove a number of quantitative and qualitative factors that are key to the credit risk assessment, potentially reducing the risk sensitivity of the measure.

Asking banks to determine their interbank RWAs on financial positions requires up to date and good quality data which assumes it is both available and accessible. But the BCBS proposal leans more on regular Pillar 3 disclosures. The Committee published its final standards for *enhanced Pillar 3 disclosure requirements* on 29 January 2015, with revisions designed to enable market participants to compare banks' disclosed RWAs and assess a bank's overall capital adequacy. Bank need to publish their first Pillar 3 report under the revised framework with their year-end 2016 financial reports.

The credit risk consultation closed 27 March 2015. BCBS plans to run a Quantitative Impact Study (QIS) to further develop its proposals but has not indicated an implementation date.

Ramping up operational risk

BCBS proposed a major overhaul of operational risk measurement in *Revisions to the simpler approaches* on 6 October 2014. It identified that banks using the standardised and basic approaches underestimated losses by as much as 50%, so it developed a new measure.

BCBS suggests replacing the net income input with a new metric called the 'business indicator' (BI). The most significant change it proposes is for banks to use the absolute values of components, e.g. gross interest income, to determine BI. The bank would then multiply its BI by a coefficient to determine the overall operational risk charge for the year. Its capital requirement would remain the average of the past three years' operational risk charges.

The Committee does not want past losses to reduce a firm's capital requirement. Banks held less operational risk capital in the period 2010-12 despite facing an increase in operational losses. The BI is composed of absolute values rather than net income figures to include past losses in setting future capital. This new BI calculation is particularly relevant to the treatment of trading book profit and loss.

BCBS identified a non-linear relationship between operational losses and bank size, with larger banks facing proportionately larger losses. To address this, it proposes a progressive weighting system that varies the risk charge depending on bank size. The banks with the largest BI figure may have to apply a 30% coefficient. Banks with smaller BIs can apply a lower coefficient, down to the smallest banks which will need to apply a coefficient of 10%.

It's unclear whether the new BI measure is a better predictor of operational capital needs or just requires 'more'. The period BCBS used to back test the BI and alternative measures was characterised by rapidly increasing operational risk losses heavily biased towards litigation costs and fines. The litmus test will be whether the BI is accurate as operational losses fall.

The consultation period has closed. BCBS plans to publish finalised proposals in 2015.

Counterparty credit risk measure enhanced

The Committee revised the standardised method for calculating counterparty credit risk (CCR) in The standardised approach for measuring counterparty credit risk exposures issued on 31 March 2014. The new Standardised Approach (SA-CCR) calculation introduces significant changes to the methodology from the current non-internal model method approaches. Starting 1 January 2017, banks will use SA-CCR to calculate CCR exposure associated with OTC derivatives, exchange traded derivatives and long settlement transactions, replacing the Standardised Method, Current Exposure Method, or Internal Model Method (IMM) shortcut method. Firms that use the IMM to calculate their CCR will not be directly affected but will need to adopt in parallel the new standardised method for calculating capital floors. The SA-CCR feeds into both the capital requirements for bank exposures to central counterparties (that come into effect on 1 January 2017), and for measuring and controlling large exposures (which will take effect from 1 January 2019).

BCBS recognises that current standardised methods of calculating CCR exposure do not differentiate between transactions with and without margin capital, accurately reflect the volatility observed in recent stressed periods nor accurately recognise netting benefits. It claims the new SA-CCR is more risk sensitive, limits the need for discretion by national authorities, minimises the use of banks' internal estimates, and avoids undue complexity.

It calibrated the SA-CCR to reflect the level of volatility observed in the recent stress period and to encourage centralised clearing of derivative transactions.

The SA-CCR involves summing the replacement cost and potential future exposure and then multiplying by the BCBS set multiplier (currently 1.4) as used by IMM firms. The potential future exposure element includes a multiplier that allows for the partial recognition of excess collateral and an aggregate add-on. BCBS also provides methodologies for calculating the add-ons.

Slight tweaks to trading book review

BCBS consulted on the *outstanding issues in its fundamental review of the trading book* on 19 December 2014. It has revised its 2013 *market risk proposal* to address perceived weaknesses in banks' risk measurement under the internal models-based and standardised approaches. BCBS reviewed responses to the 2013 consultation, feedback from a hypothetical portfolio exercise, and the results of a comprehensive QIS conducted to assess the proposed trading book framework.

Based on these results it outlined three broad areas of the fundamental review to refine:

- treatment of internal risk transfers of equity and interest rate risks between the banking and trading books, to supplement the existing treatment of internal transfers of credit risk
- a revised standardised approach using changes in the value of an instrument based on sensitivity to underlying risk factors
- a simpler method for incorporating liquidity horizons in the internal models approach.

Responses from industry spurred BCBS into making these changes. In particular, removing the cash flow requirements in determining the standardised approach will help the industry which considered it a valuable concession in its favour. The consultation closed 20 February 2015.

Laying new capital floors

BCBS consulted on capital floors: the design of a framework based on standardised approaches on 22 December 2014. It proposed that banks use a capital floor based on revised standardised approaches for credit, market and operational risk to replace the floors from the Basel I framework. The Committee is considering three options: by risk type, exposure, or aggregate RWA.

The Committee wants to mitigate model risk and measurement error stemming from internally-modelled approaches. It feels the new floors would ensure that the level of capital across the banking system does not fall below an aggregate minimum and contribute to RWA consistency across institutions, so helping investors compare banks' capital ratios. The consultation closed 27 March 2015, with the final standards planned for the end of 2015. This leaves little time for the industry to perform the required QIS and for both the Committee and banks to digest the results.

What's next?

In each area BCBS has proposed substantial changes. But viewed collectively the scale of the revisions is greater than the sum of its parts. In 2014 we may have witnessed the Committee laying foundations for Basel IV.

What do I need to do?

Firms need to act soon to prepare for the fundamental review of the trading book and the revised counterparty credit risk changes. We also expect to see the market risk proposals finalised by the end of 2015 with potential implementation in 2016. Firms should begin considering the changes they need to make across all fronts. Firms will find that some of the changes pose strategic opportunities and challenges as the market evolves. Other changes may require long lead-times to implement, particularly areas where firms' systems have to be modified, new data sourced and managed and functions such as Risk and Finance to work closer together. Beginning to plan for these changes now will help ensure a smooth transition.

There is still some way to go before the credit and operational risk consultations become finalised, followed by a long route into binding regulation. Though firms may not need to implement these in the short term, the time to influence the policy is now. BCBS has signalled its intent to run a number of QISs which we can assist you with if you are participating. We can also help you to navigate through the complexity of all these proposals, perform a deep-dive review to assess the business impact and connect the dots to draw strategic optionalities for your firm.

Glossary

ABC	Anti-Bribery and Corruption
ABS	Asset Backed Security
AIF	Alternative Investment Fund
AIFM	Alternative Investment Fund Manager
AIFMD	Alternative Investment Fund Managers Directive 2011/61/EU
AML	Anti-Money Laundering
BCBS	Basel Committee of Banking Supervision (of the BIS)
Basel II	Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework
Basel III	Basel III: International Regulatory Framework for Banks
BCBS	Basel Committee on Banking Supervision
BIBF	Bahrain Institute of Banking and Finance
BIS	Bank for International Settlements
CBB	Central Bank of Bahrain
CBK	Central Bank of Kuwait
CBO	Central Bank of Oman
CCPs	Central Counterparties
CDS	Credit Default Swaps
CET1	Core Equity Tier 1
CFTC	Commodities Futures Trading Commission (US)
CFT	Counter Terrorist Financing (translation)
CGFS	Committee on the Global Financial System (of the BIS)
CMA	Capital Markets Authority
CRD IV	Capital Requirements Directive 2013/36/EU
CRR	Regulation on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012
CTF	Counter Terrorist Financing
DFSA	Dubai Financial Services Authority
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act (US)
D-SIBs	Domestically Systemically Important Banks
EBA	European Banking Authority

EEA	European Economic Area
EIOPA	European Insurance and Occupations Pension Authority
EMIR	Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (EC) No 648/2012
EP	European Parliament
ESMA	European Securities and Markets Authority
FASB	Financial Accounting Standards Board (US)
FATCA	Foreign Account Tax Compliance Act (US)
FATF	Financial Action Task Force
FC	Financial counterparty under EMIR
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation (US)
FMI	Financial Market Infrastructure
FRC	Financial Reporting Council
FSB	Financial Stability Board
FSI	Financial Stability Institute (of the BIS)
FSOC	Financial Stability Oversight Council
FTT	Financial Transaction Tax
G30	Group of 30
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
G-SIBs	Globally Systemically Important Banks
G-SIFIs	Globally Systemically Important Financial Institutions
G-SIIs	Globally Systemically Important Insurers
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IIFS	Institutions offering Islamic Financial Services
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IMF	International Monetary Fund
IOSCO	International Organisations of Securities Commissions
ISDA	International Swaps and Derivatives Association
ITS	Implementing Technical Standards
LCR	Liquidity coverage ratio

LIBOR	London Interbank Offered Rate
MiFID	Markets in Financial Instruments Directive 2004/39/EC
MiFID II	Proposed Markets in Financial Instruments Directive (recast) (COM(2011) 656 final)
MiFIR	Proposed Markets in Financial Instruments Regulation (EC) (COM(2011) 652 final)
NAV	Net Asset Value
NSFR	Net stable funding ratio
OECD	Organisation for Economic Cooperation and Development
OIC	Organization for Islamic Cooperation
PCBS	Parliamentary Commission on Banking Standards
PRA	Prudential Regulation Authority
QCB	Qatar Central Bank
QFMA	Qatar Financial Markets Authority
QFCA	Qatar Financial Centre Authority
QFCRA	Qatar Financial Centre Regulatory Authority
QIS	Quantitative Impact Study
RDR	Retail Distribution Review

RRPs	Recovery and Resolution Plans
RTS	Regulatory Technical Standards
SAMA	Saudi Arabian Monetary Agency
SCA	Abu Dhabi's Securities and Commodities Authority
SEC	Securities and Exchange Commission (US)
SIPP	Self-invested personal pension scheme
SOCA	Serious Organised Crime Agency
Solvency II	Directive 2009/138/EC
SSAP	Statements of Standard Accounting Practice
SYSC	Senior management arrangements Systems and Controls sourcebook, UK regulation
T2S	TARGET2-Securities
TR	Trade Repository
UAECB	United Arab Emirates Central Bank
UCITS	Undertakings for Collective Investments in Transferable Securities

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