With apologies to Hasbro

Stay out of jail

A string of stinging fines in recent months has driven a renewed focus on compliance, taking it to the top of the risk agenda, writes Elliott Holley

Global banks have paid a total of $261.3 billion since 2008 according to the CCP Research Foundation – the equivalent of the annual GDP of the United Kingdom.

The good news is that in future, institutions found to be in violation of the regulations might not get fined – the bad news is that senior officers of the company might face jail.

Given the severity of the punitive measures taken by global regulators – and their frustration with the fact that several institutions seem to be content to pay fines rather than address the underlying issues, some observers are starting to question whether the whole approach banks take to risk needs to be revisited.

"Risk should not be an after the event activity," says Matt Newman, executive vice president at SunGard Financial Systems. "Banks need to understand what the risk is before they act. There are huge fines for weak processes, and that is helping to convince people to invest in this area."

No matter how good a bank's intentions, however, improving risk processes can be difficult, especially when dealing with a massive globally active business that has been built up through M&A activity over decades. Adding to the difficulty is the complexity of the technology that links front, middle and back office together – and the historic disparity in investment between the front office and the rest of the business.

According to Newman, one of the key challenges for large global financial institutions is ensuring that the right information gets to the right person at the right time. This inevitably involves a trade-off between completeness of information and delivering it as quickly as possible, which has to be addressed by compromises such as using local caches for time-sensitive information.

"Can I wait a few seconds to trade? It depends on a number of factors,

including what the asset class is," he says. "With an instrument such as swaps, you have a minute or so, which allows you time to gather information. But if you are dealing with FX, you have to turn it around fast otherwise you will lose the flow. A quarter of a second latency is a lifetime in some asset classes. After all, the perfect information arriving too late doesn't help anyone."

One of the biggest handicaps for global financial institutions attempting to keep a handle on their risk is the passage of time. Sanctions lists and AML screening requirements continue to change, and as cyber threats grow in sophistication and complexity, so too does the burden on bank systems designed to keep things in check.

According to Robert McKay, head of compliance solutions at Accuity, many banks have first generation filtering systems in place, even though transaction levels have increased markedly along with the number of accounts that these systems are required to monitor. For example, the recent sanctions against Russia have had an impact on all kinds of transactions, from cross border payments to equity transactions.

"In the old days, the bank's chief compliance officer would sit with his operations team and analysts and figure out a screening process that kept the best balance between compliance and the need to avoid using unreasonable amounts of resources," says McKay. "This often involved setting up some sort of calendar of events – once weekly or once monthly screenings – where the bank could check its existing lists against any incoming changes. But what happens in the gaps between screenings?"

McKay adds that Accuity's own approach to solve the problem is to offer banks cloud-based tools that automate the process, using continuous monitoring. In this system, any change to a sanctions list or a regulatory requirement automatically triggers a review of the bank's own processes to ensure that the change is dealt with. He says this happens in near real time, and adds that this makes the workflow more manageable for the bank's compliance team because it avoids the massive spikes in activity and workload associated with weekly or monthly checks.

Trade finance is another area fraught with challenges, since the process around issuing letters of credit is still largely paper based. Banks active in this area will typically need to employ significant human resources to trawl through these and ensure that there is nothing amiss, he added, suggesting that automation might be useful here too.

In some ways, compliance is not even the most pressing challenge faced by banks. The risk of criminal activity by individuals acting both outside and inside the bank itself is also a major threat. According to McKay, one of the most dangerous threats may be when an employee of the bank turns rogue, and begins using their knowledge of the weaknesses of processes to their own advantage. This could involve manipulating the systems in the middle or back office, causing a transaction to be stopped.

"This is of particular concern to banks, and a number of organisations are looking at ways to employ anti-stripping tools within their risk controls," he says. "These tools have really come into their own in the last 18 months, and that speaks to the desire of the sector to get control over these risks."

Inevitably, regulation also plays a key role. The rules set out by the Basel Committee on Banking Supervision, for example, add to the demands placed on financial institutions and the technology systems that underpin them. The BCBS has already set out standards for how banks should calculate credit and margin – and according to Newman, this means that banks no longer need to develop a proprietary model to solve these questions. Instead, they are being herded towards a common standard and method. Banks are being forced to pay huge fees if they deviate from the direction of travel imposed on them by the regulator – namely recapitalisation and a shift away from trading bilateral OTC derivatives contracts, for example.

The BCBS 239 reporting guidelines from Basel also set out tough requirements in terms of monitoring the bank's own activity. The rules require a bank to be able to track all the data it has used in its calculations, what model was used to interpret the data, where the data was sourced, and what assumptions were involved. Newman adds that this is a relatively exacting set of requirements.

"Basel is designed in part to ensure the numbers are correct," he says. "But it's going to be expensive, long and painful for the banks to be fully compliant with all these principles. People are starting to realise how much it will all cost – we are talking billions of dollars. But then again, the fines for not complying are also in the billions."

The Basel rules are not the only thing keeping risk officers awake at night. Around the world, there are also a number of national rules and international regulatory initiatives that need to be kept in mind. One of the more notable of these is EMIR, the European Commission's drive to reform derivatives markets by shifting the bulk of OTC trades onto central clearing and to introduce reporting to trade repositories. The reporting obligation under EMIR was introduced in February, while the clearing obligation is expected to take effect in 2015. But the complexity of the regulation also lies in the fact that it overlaps with other regulations, such as MiFID II, which also introduce similar but different requirements – potentially leading to confusion and, in the worst case scenario, catching financial services firms unprepared.

"There's a lot more to do under EMIR," says Hugh Daly, chief executive at Message Automation. "But MiFID II and MiFIR will also bring more requirements on derivatives trade reporting. The larger players will now have a real time reporting obligation under MiFID II in derivatives, which under EMIR they wouldn't have because EMIR is T+1. If you put in place an EMIR-only solution for your trade reporting, you may have to revisit that because you've built an overnight process and it needs to be a real time process."

The regulation also poses other challenges for the industry as a whole, not just the individual firms. According to Daly, at the end of next year uncleared bilateral trades will now require margin to be posted, potentially on both sides of the trade to cover the counterparty risk. But since there is no real industry infrastructure for this to happen, the new rules raise more questions than they answer.

"If there are just two parties to the transaction, who decides how much the margin is? And where does it go? If the trade is done over the phone, there is no mechanism to cover that. The industry is campaigning for the December deadline to be put back, and they may be successful – but the regulation isn't going away," added Daly. "Non-cleared trades will become very expensive to process if you have to post significant margin, and that's quite a threat to firms that don't have the systems in place to deal with it."

Daly added that the challenge also extends to the legal agreements in place between counterparties, which are widely considered insufficient at present to meet the new regulatory requirements, since there may need to be up to 250,000 collateral agreements renegotiated and rewritten to fit the new requirements.

Beyond the challenges to the market participants, there is also the question of whether or not the new rules actually achieve their aim of making the market safer and reducing systemic risk in financial markets. Daly warns that new regulation can never eliminate risk completely – it simply moves the risk from one place to another, with checks and balances to ensure things do not get out of hand. In the case of the G20 principles agreed at Pittsburgh in 2009, and then implemented in Europe through EMIR and MiFID II and in the US by Dodd-Frank, the solution involves concentrating risk at the CCP.

"The biggest risk to the UK taxpayer is a default at LCH," says Daly. "There's a few trillion in there, it's probably a bigger risk than any one of our large banks. They do what they can with default waterfalls, but you can't say it's completely risk free, because it's not."

Daly added that while the principle of transparency behind the G20 agreement is a sensible one, but the implementation since then has called the viability of the international reforms into question. Differences between regulators on both sides of the Atlantic have led to differences in implementation and in the speed at which the reforms are introduced. There are also multiple trade repositories and CCPs to be considered, as well as different requirements on single and double sided reporting, among other details.

In addition, questions of reciprocity and extra-territoriality are also an issue. In particular, a European clearing house has to be approved by the US if it interacts with US firms, whereas a US clearing house doesn't have to be approved by the European authorities because the EU recognises US rules as equivalent. While ESMA in Europe does have reciprocity with regulators in Singapore, Australia and Canada and vice-versa, the US does not recognise any other nation's rules.

"The fact the regulators can't agree and get their ducks in a row really doesn't help," he says. "In the worst case scenario, you end up with regulatory arbitrage and confusion and fragmentation. And there are still reforms to come in several countries – Switzerland, for example – while Canada has just implemented its own changes and the US is quite far ahead with reporting and clearing. You end up needing a platform that is designed to serve multiple jurisdictions, because otherwise you can't be completely sure whether you are compliant or not."

And being compliant these days could mean the difference between passing go or going to jail … ***BT***

THE FINES PILE UP

December 2012: HSBC fined $1.9 billion in December 2012 for AML failures relating to its Mexico subsidiary

November 2013: JP Morgan settles with US Justice Department for $13 billion

January 2014: JP Morgan pays $2.6 billion to victims of Bernie Madoff fraud, bringing the total it has paid in two years to $25 billion

July 2014: BNP Paribas fined $9 billion for violating US sanctions.

August 2014: Bank of America fined $16.6 billion for mortgage fraud – the biggest single bank fine in history.

August 2014, Deutsche bank fined £4.7 million for incorrectly reporting its transactions between 2007 and 2013

November 2014: six banks collectively fined £2.6 billion by the UK FCA for manipulating foreign exchange rates

November 2014: RBS fined £56 million for an IT failure two years earlier, which left customers unable to access their accounts for up to a month.