

White Paper

Banking Risk and Compliance in Asia

*The
Competitive
Advantage
of Excellence*

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Objectives

This white-paper reviews emerging regional issues for financial services firms across Asia¹, and outlines practical responses from their risk and compliance management functions. The key message is:

Sustainable competitive advantages can be created for firms in the Asian region, without compromising local resilience to global economic turbulence - **by extending the operational scope of risk and compliance management** functions along a firm's financial services value chain - **to help achieve excellence** through an integrated programme of new and existing initiatives, **focused on the local practicalities** of global challenges and opportunities.

Excellence in Asian Banking

High savings levels, cautious regulations, superior quality capital and a more robust capacity to generate liquidity are usually cited as contributing factors behind banking resilience in Asia over the past decade (Pomerleano, 2009), relative to most other regions in the global financial services industry. A stable competitive environment has also proven useful, protected in some territories by regulatory limits on currency convertibility, barriers to extreme cross-border flows of liquidity, and restrictions on participation in local markets by foreign institutions. But conservative attitudes in management, and lessons learnt from the financial crisis of 1997 in this region, have undoubtedly been the primary reasons why many such firms in Asia are currently enjoying significant advantages over their counterparts elsewhere.

A recent IMF Global Financial Stability Report, published in April (IMF, 2011), implies that maintaining these advantages in the future will be achieved through exploiting regional differences. The report illustrates the contrast between regions in terms of shifts in economic policies. It calls for many advanced economies to move from policies of supporting their local industry to making structural reforms – which it characterizes as less “leaning” and more “cleaning” of the financial system. Whereas Asian economies are among those the report urges to “limit overheating” so that “cleaning” can be avoided later. If local economies implement divergent policy shifts, as the IMF proposes, international regulatory pressures on firms in Asia may be interpreted operationally in a different way to other regions. This suggests more operational involvement will be necessary from local risk and compliance functions to help manage the consequences, which may also be true for changes in non-regulatory economic circumstances. If responses are based on existing good practices and implemented as suitable adaptations, then new possibilities can emerge quickly in Asia. Enabling competitive advantages to be generated by improving how local opportunities are leveraged to achieve excellence within shifting regulatory constraints.

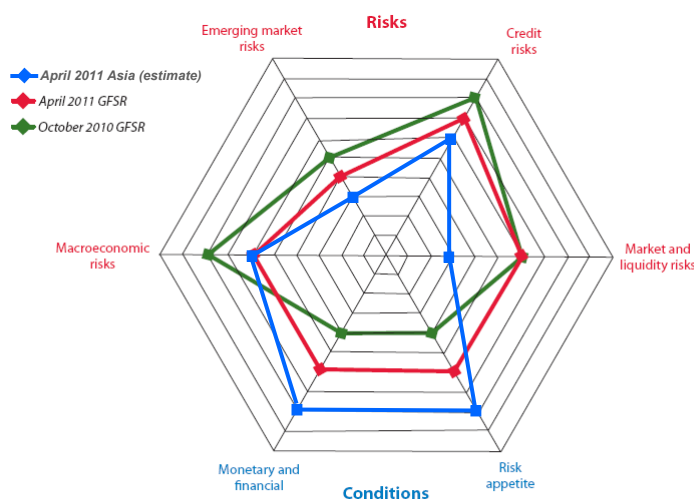
¹ **Asia** - is defined in this paper as territories in the geographic regions of Northern and South-eastern Asia (ASEAN), and Australia. With special interest in those territories that have significant financial services industries, such as: Australia, China, Hong Kong, Japan, Malaysia, Singapore, South Korea, and Thailand.

The following sections begin by summarizing a general consensus among respected observers about major changes likely to impact this industry in Asia. Then the remainder of the document considers internationally approved ways to manage that change, which are organized into a framework for exploring practical responses suitable for this region. In conclusion, a few practical initiatives are recommended as potential next-steps.

Emerging Challenges

The key challenges facing the financial services industry in Asia over the next decade are well known, although not totally free of controversy (Arner and Park, 2010). Compiling a list for this section was, therefore, fairly easy. But finding agreement about the relative importance of those challenges under various circumstances proved to be more difficult. Too many factors need to be considered when reaching conclusions, and they are often very subjective in nature and specific to individual firms. If the intention here is to provide a step-by-step prescription for what a firm can do about each challenge, based on a standard set of assumptions, experience tells us this is unlikely to work.

So this paper makes no judgements about such matters. It builds a short list out of what others say are the challenges, and shows how to match each challenge to appropriate responses at individual firm-level in the form of functional initiatives. Then it suggests combining related initiatives across an enterprise, with an operational excellence² programme, using a risk-based framework for prioritising implementations according to a firm’s capability of responding effectively. Judgements about importance, priorities, and even relevance, are assumed to be provided by responding firms for their own circumstances using the framework of sample initiatives and recommendations given here as guidance.



Note: Away from center signifies higher risks, easier monetary and financial conditions, or higher risk appetite.

Figure 1. Modified Global Financial Stability Map. Source: IMF and estimates for Asia by Thomas Ilin.

² **Operational Excellence** – is the goal of achieving agility and resilience in enterprise operations through the successful implementation over time of effective operating models, with appropriate transition plans, that keep ahead of emerging challenges and competitors by continually improving operational capabilities for the benefit of all key stakeholders of that enterprise. *Thomas Ilin, 2008. Cranfield University working papers.*

Figure 1 begins this process by looking at an estimate of where the Asian financial services industry is placed on the IMF Global Financial Stability Map in April 2011. It summarizes the cumulative effects of responses to ongoing challenges between October 2010 and April 2011, in terms of changing risks and conditions.

Using that current state assessment, the next two sub-sections examine international regulatory pressures and how policy shifts are implemented locally, to get a better understanding of the Asian region context for risk and compliance responses. Then each challenge in this paper’s short-list is considered individually.

A Global Context

During the ongoing reverberations of the global financial crisis of 2008, regulatory focus has shifted from a light-touch approach to more direct engagement with the financial services industry worldwide. The objectives are to reduce uncertainty and increase transparency through fundamental improvements in the quality and frequency of bank reporting, for closer scrutiny and supervision. At the same time, new global policies are being introduced to stimulate economic recovery, which are being implemented regionally in support of local priorities. The world is now entering a containment phase of this crisis, which is about managing the dynamics of the sovereign-bank feedback loop to avoid what the IMF calls “a pernicious cycle of deleveraging, weak credit growth, and falling asset prices”.

While ongoing structural reforms, harsher crisis avoidance policies and punitive new regulatory measures are being aimed at key sectors of the global industry, such as banking, Asian reforms have continued along a more growth-oriented path out of turbulence. Figure 2 takes an influential regulatory view of banking challenges driving these trends, and their broad policy responses being implemented globally. This provides a useful structure for examining the nature of equivalent challenges in Asia, to propose appropriate local risk and compliance recommendations at firm-level.

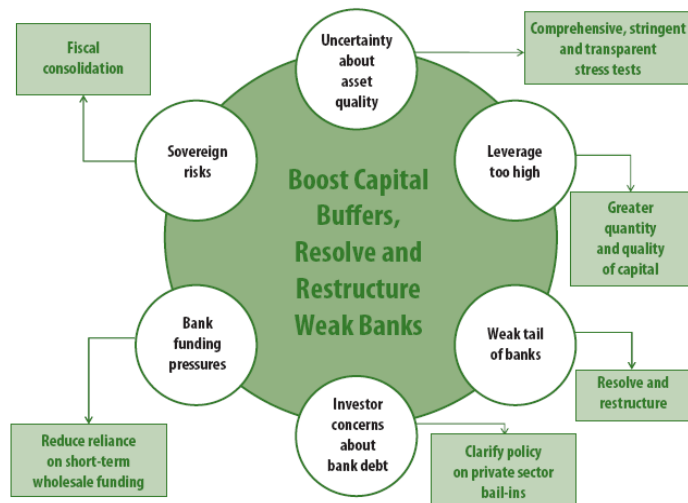


Figure 2. Policy Solutions to Banking Challenges.
Source: IMF

But first, the global story behind these challenges can be summarized as follows.

Uncertainty about asset quality: For example, property exposures vary significantly due to uncertainty about the value of all types of real estate, and what to do about the disposal of repossessed properties. While concerns are growing about false exposures created by such practices as rolling-over otherwise delinquent loans and the book value pricing of sovereign debt holdings that have substantially lower market values.

Leverage too high: There is concern about the number of banks globally that are undercapitalised. In a sample of EU banks analysed by the IMF in April 2011, they found core Tier 1 capital ratios were still below 8 percent for 30 percent of those banks, or nearly 20 percent of all assets. This is expected to adversely affect funding costs and capital generation over the near future.

Weak tail of banks: Overcapacity in the banking system is damaging profitability and creating an unstable competitive environment. The policy objective is to create a balance between more competition and fewer weak banks. Industry restructuring, consolidation and business model realignment is proposed for solving the problem. However, pressures on larger banks to divest branches, and the entrance of new competitors, may complicate matters in some regions.

Investor concerns about bank debt: In anticipation of tougher regulatory environments, uncertainty about bank asset values is causing investors to factor bank defaults into their decisions. Concerns about the availability of assets to repay creditors, market valuations of those assets, and repayment priorities in the event of failure are all taking on new significance. And so, risk-based repricing of assets and consequent write downs may begin to generate a self-fulfilling effect on bank debt dynamics.

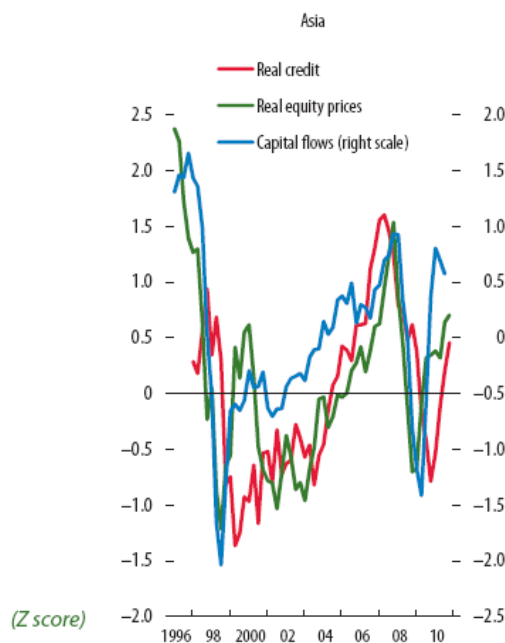
Bank funding pressures: Global banks collectively face a surge in rollover funding requirements for their \$3.6 trillion burden of debt due to mature over the next two years (2011/12). Increased reliance on short-term low-interest funding in the early stages of the crisis created this concentration risk. Banks will now have to compete for scarce funds against the refinancing requirements of higher sovereign debt. Creative solutions must be found for any shortfall over this period. Negative news could quickly throw a number of systemically important financial institutions (SIFIs) into difficulties, such as an increased risk of sovereign debt defaults, or an untimely fall in demand for unsecured senior bank debt as a consequence of Basel III preparations. The limited global pool of deposits is unlikely to provide an alternative source of sufficient funds, even with attractive savings incentives.

Sovereign risks: Meanwhile concerns over sovereign debts are beginning to create a feedback loop which indirectly exacerbates bank debt funding attempts by eroding confidence in government guarantees. This is further complicated by the generally high ratio of bank holdings in troubled government bonds to their overall capital, which directly exposes them to sovereign credit risks. Both are symptoms of this sovereign-bank adverse feedback loop. Crisis situations in Greece and Ireland are notable recent examples of the trend. While Japan and the United States face public debt rollovers in 2011 of 56 percent and 29 percent of GDP, respectively.

A Regional Perspective in Asia

Although global instability is not fully manifested in the Asian region, some aspects of it are present, while others can still have indirect consequences locally (Sheng, 2010). Perhaps the key differentiator of successful banks will be a realization that many of the risks arising from emerging challenges need a more coherent local approach. Risk management tends to be operationalized in a fragmented way in most Asian banks. One functional area may be managing 'normal' credit and operational risks, while another takes care of treasury risks, at the same time as sovereign and other counterparty risks are being managed elsewhere, and so on. Compliance brings the reporting of these risks and exposures together in a consolidated form, but enterprise risk management is so much more. A true enterprise approach to risk management is not just enterprise-wide, it should encompass all internal and external sources of risk and their related exposures in a single coherent response. The remainder of this paper looks at what that could mean for firms in Asia. It begins in this sub-section by taking a local perspective on sources of the 'bank funding pressures' challenge.

Capital Flows: Major capital outflows from Asian economies occurred during the regional crisis of 1997, and during the current global crisis following the Lehman collapse in 2008. Their causes were different, although their effects appear similar. Figure 3 shows capital flows, real equity prices and real credit for Asia over a period of time that includes both crises. A strong correlation between those variables suggests that capital flows into and out of the region have an immediate impact on the economy. This can give rise to both direct and indirect 'bank funding pressures'.



Sources: IMF International Financial Statistics database; Haver Analytics; and IMF staff estimates.
 Note: Portfolio and other investment as a percentage of the size of financial markets.
 Year-on-year real credit growth. Real equity prices deviations from trend. All variables are transformed into a z score (difference from average in terms of standard deviation).
 Asia includes India, Indonesia, Korea, Malaysia, and Thailand;

Figure 3. Capital Flows and Effects.
 Source: IMF

When the opposite sides of capital flows are considered (see the 2010 example in Figure 4), an appreciation can be gained about contrasts between the economic cycles of different regions. Understanding where Asian economies are in these cycles at any point in time, and how challenges emerge from them, will be key to establishing competitive advantages at firm-level. Excellence in risk and compliance management is the critical enabler for that understanding.

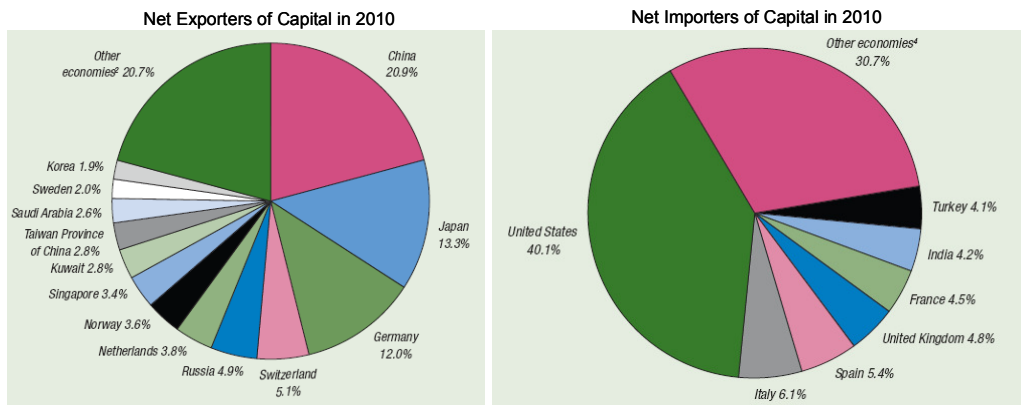
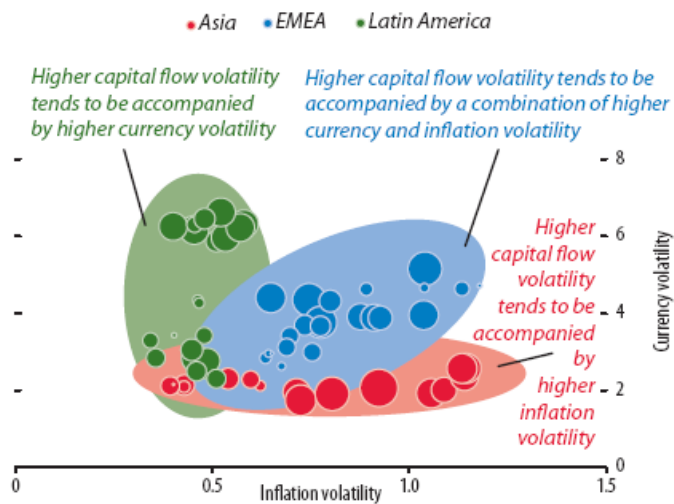


Figure 4. Net Exporters and Importers of Capital in 2010. Source: IMF.

Volatility Effects: Since the last quarter of 2010 until April 2011, capital flows have completely reversed in Asia, now making it a net importer. Figure 5 shows how over the past decade in this region, higher capital flow volatility has exhibited a close relationship to higher inflation volatility.

(2001:Q1 – 2010:Q4, bubble size is capital flow volatility in z-score calculated for each region)



Sources: Haver Analytics; national authorities; and IMF staff estimates.

Note: Three-year standard deviation of (1) quarterly percentage change in goods price index (x axis); (2) quarterly percentage change in nominal effective exchange rates (y axis), and (3) quarterly percentage point change in portfolio investment as a percentage of GDP (bubble size), which is shown in a z-score (deviation from average in the number of standard deviation) calculated for each region, showing data points with above-average capital flow volatility.

Figure 5. Median Volatility of Inflation, Currencies and Capital Flows. Source: IMF

Whereas in EMEA this effect has not been present. Reasonable short-term risk assumptions can be made based on this type of information. Here again, foreknowledge about challenges at a macro level can be used to guide enterprise risk management policy and mitigation tactics. Too often, clarity of thinking about such matters is missing at firm-level, or disconnected from practical decision-making. Risk management is too introspective and still not sufficiently pro-active, while compliance management is by nature too retrospective.

Impact on Bank Assets: Similar opportunities can emerge in Asia from macro-economic effects on such things as: regional economic priorities, local differences of emphasis on regulatory obligations, and competitor responses to challenges. Insights from these effects can be used to guide pre-emptive actions at firm-level, and for enterprise risk-orientation. For example, Figure 6 shows how capital flow volatility in Asia has affected total assets in local banks, and consequently their average Tier 1 capital ratios. This volatility has a broad range of firm-level implications, in areas such as: bank funding, capital adequacy, asset utilization, regulatory tracking of foreign investments, client capital movement transparency and disclosure, sanctions compliance, and so on. All of these implications should be part of internal stress-testing.

Also, the differences between bigger and smaller banks is pronounced. There appears to be a tipping point in asset size, beyond which asset growth accelerates rapidly. Banks with total assets below that size may suffer a credibility gap, or may need to defend a strong niche presence, otherwise they will be prone to the risk of being targeted for acquisition. Risks and exposures associated with this tipping point should be identified, for banks below it.

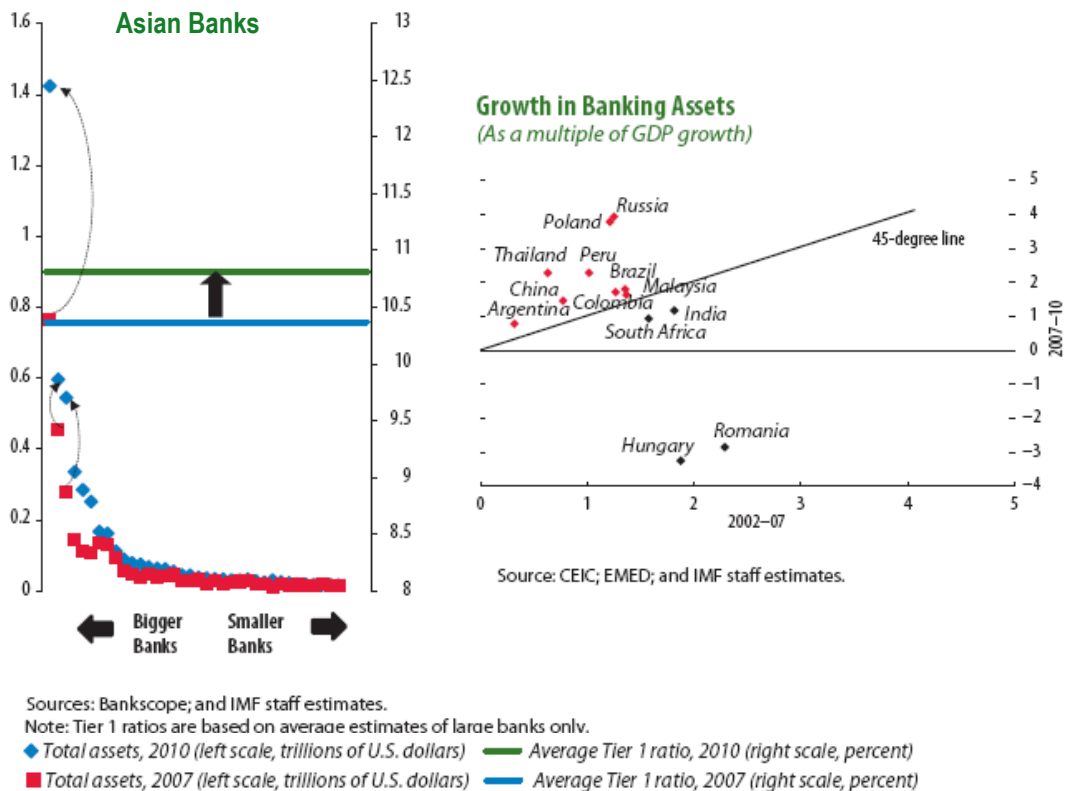
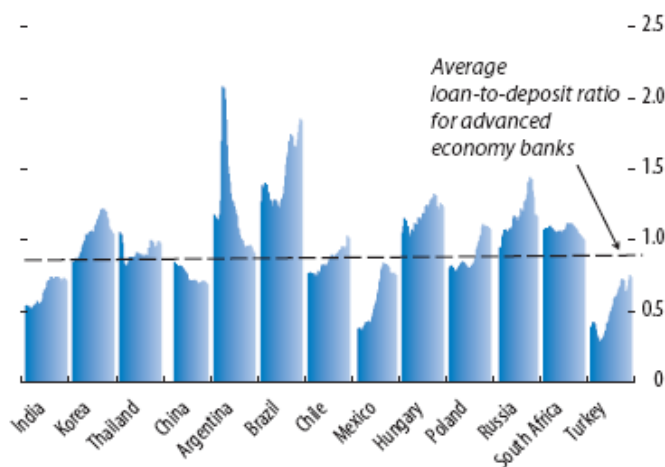


Figure 6. Bank Asset Growth and Capital Positions.
 Source: IMF

Bank Funding Implications: If sound risk and compliance management practices are applied to a wider perspective, as suggested, then improved responses to challenges become feasible. Figure 7 illustrates loan-to-deposit ratios over the past decade for a selection of so-called emerging market economies. For Asian economies such as China, where this ratio remains below parity, deposits have been sufficiently high to cover all lending requirements. Therefore funding by money and capital markets, or a dependency for funding from capital inflows, were not major concerns. In this type of situation, risk focus shifts from liquidity constraints to other types of risk, associated perhaps with becoming a funding hub for the region, or managing the investment demands of a large market share of regional private wealth. In other regions with inadequate deposits capital flows had the opposite effect, and called for different responses. However, that advantage for Asia has recently begun to erode.

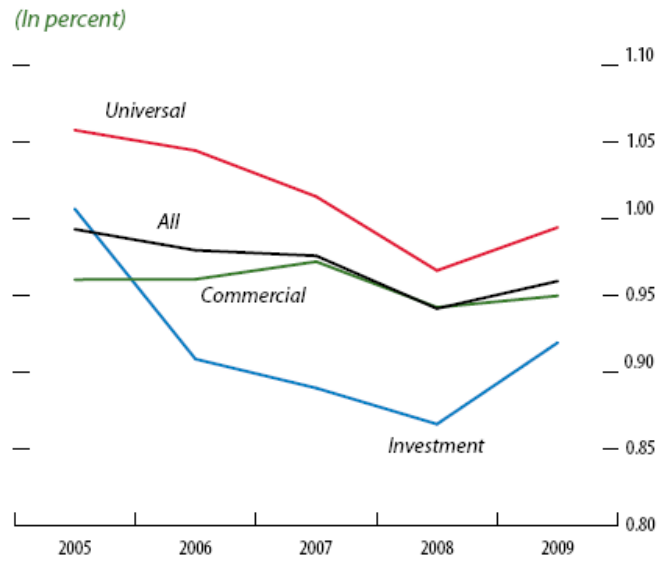


Sources: CEIC; EMED; and IMF staff estimates.

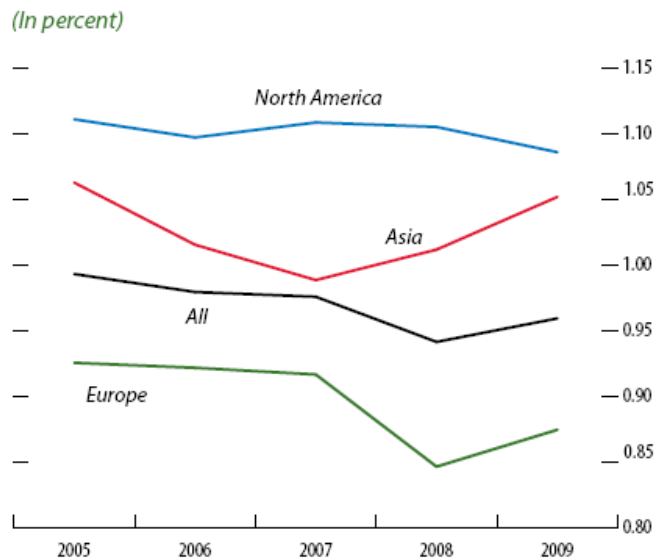
Figure 7. Loan-to-Deposit Ratios, 2000 – 10.
Source: IMF

Funding Variations by Business Model: Having so far examined illustrations for the Asian region of how the challenge of ‘bank funding pressures’ can arise from capital flows, which is just one of many overlapping trends affecting local firms, actual risks can be seen to materialize when different business models are factored in. Figure 8 shows a global analysis of business models and economic regions by the net stable funding ratio, NSFR. This is a Basel III liquidity standard. In simplified terms it is the funding available to a bank divided by its required funding. It should be greater than 1.00, or 100 percent. The IMF calculated these ratios using various assumptions, because all necessary data will not be available until Basel III is implemented. However, they believe that reasonable approximations were achieved.

The purpose of this analysis is to show how the challenge of ‘bank funding pressures’ arising from capital flows varies by business model. Many of the risk considerations of other trends, such as inflation, will also vary according to such factors. Risk mitigation techniques at firm-level can only be effective when they incorporate this type of broad understanding. Otherwise frequent surprises lead to constant damage limitation.



Sources: Bankscope; and IMF staff calculations.



Sources: Bankscope; and IMF staff calculations.

Figure 8. Net Stable Funding Ratio by Bank Business Model and Region. Source: IMF

Developing an Asian Approach

The previous section briefly discussed a broad regional perspective on capital flows and bank funding. It gave a few illustrations of how the challenge of ‘bank funding pressures’, identified by the IMF in Figure 2 as one of six key banking challenges, could benefit from improved enterprise risk management in Asia, that includes external sources of risk and their related exposures in a single coherent response.

In this section, a response outline is proposed for local firms to develop into their own approach to enterprise risk management. It takes an internationally approved framework and combines it with techniques that are appropriate for Asia and practical recommendations that address local circumstances.

The intention is not to write a text-book on this subject, but to produce an introductory discussion document for use in workshops.

To begin with, it is important to establish what makes the Asian region different.

Special considerations for Asia: There are many ways to differentiate Asia from other regions of the global financial services industry. However, for the purpose of qualifying the features of a regional approach to enterprise risk management and integrated regulatory compliance, a few special considerations for Asia stand out:

1. The banking system is still being constructed in most Asian territories, along with legal and regulatory frameworks for financial services, at a time when the region is facing complex organizational and technical demands from new requirements.
2. The worldwide shortage of suitably skilled and experienced professionals in financial services risk and compliance management is particularly acute throughout all territories in Asia.
3. The region continues to be an operational 'counterparty' to other regions, often taking complementary roles in global trends as in capital flows, and occupying a different place in economic cycles to most other regions that requires its own unique economic policies and priorities.
4. There are significant operational variations between territories in the region, as in regulatory constraints on key activities, foreign competition, currency convertibility, client secrecy, tax rules, etc.
5. Many practical constraints in this region may not be priorities or even exist elsewhere, as in dimensional issues (e.g. sizes of customer bases, numbers of branches, complexity of organizations), regional variations in sophistication, gaps and weaknesses of infrastructure readiness, etc.
6. A lack of standards across the region, and even in individual firms, creates inconsistencies in products/offerings, contracts, organizational structures, decentralized policy making, information structures and availability, regulatory reporting submissions, supervision methods, etc.
7. Major differences in customer-oriented cultures and ideologies, ranging from sophisticated relationship management to basic account centricity (lacking the ability to identify a unique customer across provinces and territories).
8. A need for reconciliation between the complexities of international and local regulatory obligations.

Although they are well known, and generally acknowledged, most banks never get around to addressing these considerations directly. Doing so is considered such a monumental task that a preferred approach is to wait until governing authorities deal with the big issues, while banks simply try to delay some of the effects with limited firm-level initiatives. Even when firm-level responses are organized using an internationally approved framework, the methods employed are often applied piecemeal in separate functional areas of a bank. Development of an approach suitable for Asia calls for recognition of the good progress that has already been made in initiating enterprise risk and compliance management, while improving the returns on joint efforts through better coordination. As the benefits of this approach take shape, new opportunities for competitive advantage will emerge.

The COSO framework: A framework for this purpose was developed over a decade ago by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (Steinberg, 2004). Since then thousands of organizations have used it as an enterprise risk management tool for coordinating their improvement efforts. It takes the form of a two-volume report which defines enterprise risk management, provides a framework for achieving it, and illustrations of application techniques for use with it. This white paper does not attempt to replace the COSO report. However, certain improvements are suggested for the Asian region.

In summary, COSO defines the achievement of value through enterprise risk management as encompassing:

- Aligning risk appetite and strategy.
- Enhancing risk response decisions.
- Reducing operational surprises and losses.
- Identifying and managing multiple and cross-enterprise risks.
- Seizing opportunities.
- Improving deployment of capital.

Building on COSO foundations, this white-paper outlines:

- How variations of the global challenges that confront Asia identified by the IMF can be managed more effectively, within the context of eight special considerations for this region mentioned at the beginning of this section.
- How the COSO framework can be increased in scope to integrate compliance management.
- What ‘seizing opportunities’ could mean in Asia to achieve competitive advantages.

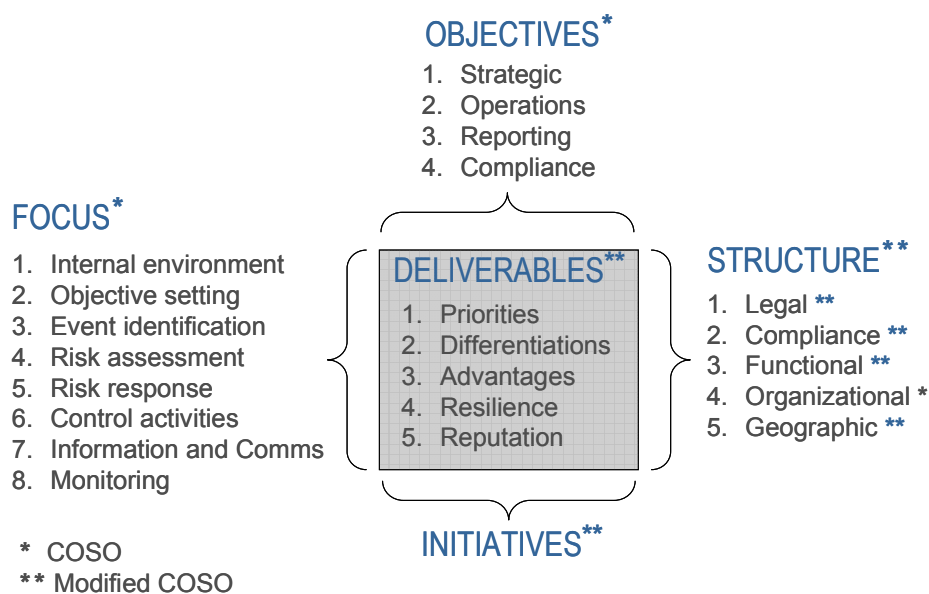


Figure 9. The Modified COSO Framework

Global challenges and Asia: Figure 9 shows a modified version of the COSO framework, as proposed by this white-paper, for an operational excellence approach to enterprise risk and compliance management in addressing the local impacts of challenges confronting Asia. Key differences to standard COSO involve more STRUCTURE dimensions in the base framework, with a new focus on DELIVERABLES designed for the Asian region which can be assigned to implementation INITIATIVES. Operational excellence (see footnote 2 on page 5) is represented in the framework by continual improvement INITIATIVES in risk and compliance supporting a firm's operational agility and resilience. The overall purpose is to populate a framework with information about the implications of risk and compliance challenges for an enterprise, and to identify how the firm is dealing with them, in a way that can be used to coordinate and control response initiatives. It is a management tool for taking confusing complexity and organizing it in a meaningful way to drive solution implementation. As with all tools, its effectiveness depends on how well it is used.

The firm-specific contents of this framework can be populated by output from cross-organizational workshops, steering committees, risk and compliance policy groups, and regulatory authorities. Each firm will have different contents derived from their own priorities, capabilities and current situation. Beyond individual firm boundaries, special considerations for the Asian region (see the eight listed earlier in this section) can be incorporated into framework contents by appropriate firm-level DELIVERABLES. For example: special consideration number 6 (lack of standards across the region) might call for the local adoption of international standards from different sources (World Bank, IMF, BIS etc), in line with international regulatory obligations, to be created as DELIVERABLES assigned to INITIATIVES addressing 'reporting and compliance' OBJECTIVES, with a 'monitoring' FOCUS, for 'legal' 'compliance' and 'organizational' STRUCTUREs in a firm.

Incremental development of framework contents is the most realistic way forward, beginning with some representation of the current situation and ongoing pre-framework initiatives. As a consolidated view of the firm is constructed, enterprise risk and compliance coordination, control and responsiveness become easier. Most importantly, the framework should be used as a tool for achieving complex interdependent objectives through assigned deliverables. It is not an end in itself.

Integrating Compliance Management: 'Compliance' is already among standard COSO OBJECTIVES. Modified COSO simply extends a firm's STRUCTUREs to explicitly address other structural views, such as compliance obligation networks. Then standard COSO interactions apply to these new 'compliance' STRUCTUREs.

Although risk and compliance are distinct functional areas in a firm, usually managed by separate organizations, they are integrated within modified COSO for control and coordination purposes. With the increase in rule-based regulation invoking punitive fines for breaches, the effects of non-compliance are becoming a significant risk. Conversely, risk-based management is becoming a pre-requisite of compliance. So integration of risk and compliance management in the framework helps to promote more prudent decisions.

Seizing Opportunities in Asia: When a consolidated view of the firm has been constructed based on its current situation, with ongoing pre-framework initiatives and operational excellence initiatives beginning to deliver results, new opportunities to establish competitive advantages appear. Sometimes they are obvious, as in improved abilities to satisfy existing customer demands, or giving customers access to risk management facilities. Whereas, at other times exploration is necessary to find advantages, as when compliance mandated restructuring of a firm transforms previous risk concentrations and creates new strategic partnership opportunities. After reviewing regulatory obligations in the region, the final sections of this white-paper look at a few potential opportunities and practical initiatives.

Regulatory Obligations

Regulatory changes are only recently beginning to gather momentum in the Asian region (Sheng, 2010), with Australia, Japan, Korea and Singapore leading the way. While other local territories still have fragmented institution-based banking regulations. When international regulations are added into this mix, the compliance obligations of individual enterprises will probably become even more intimidating.

Within the region there is a complex network of local regulations and associated regulatory and supervisory authorities covering financial services (Smith, 2011), each with different powers of enforcement. For example, in China there is: the China Securities Regulatory Commission (CSRC), the China Banking Regulatory Commission (CBRC), the China Insurance Regulatory Commission (CIRC), and the People's Bank of China (PBOC). Although many countries in regions outside Asia have similar numbers of key local authorities, in Asia they are not yet coordinated by a region-wide macroprudential organization. Consequently, satisfying local compliance obligations across multiple jurisdictions at the same time as keeping international authorities happy is becoming a key operational risk in its own right.

The modified COSO framework discussed in the previous section is an essential tool for managing that complexity. This section looks at how it can be used for managing two new sets of international regulatory demands: Dodd-Frank, and Basel III.

New International Regulatory Demands

Table 1 shows the IMF's policy solutions and key banking challenges from Figure 2 in tabular form. Each cell represents a potential solution to a challenge. Entries in some cells indicate solutions that are implemented by the Dodd-Frank Act and/or Basel III. Each entry suggests some direct contribution in solving a challenge, but this may change as local regulators decide on their interpretations. From those entries the two regulatory demands currently appear to have overlapping objectives, and similar gaps. However, Basel III is an implemented regulation, with a lot of published detail about how it achieves its purpose, whereas Dodd-Frank is more of a legal statement of intent and responsibility, with detailed regulations yet to be defined. The next sections describe the high-level scope of their demands.

Policy Solutions	Comprehensive, stringent and transparent stress tests	Greater quantity and quality of capital	Resolve and restructure	Clarify policy on private sector bail ins	Reduce reliance on short-term wholesale funding	Fiscal consolidation
Challenges						
Uncertainty about asset quality	Basel III Dodd-Frank	Basel III Dodd-Frank				Basel III Dodd-Frank
Leverage too high	Basel III Dodd-Frank	Basel III Dodd-Frank				
Weak tail of banks			Dodd-Frank			
Investor concerns about bank debt		Basel III Dodd-Frank		Basel III Dodd-Frank	Basel III Dodd-Frank	Basel III Dodd-Frank
Bank funding pressures	Basel III Dodd-Frank				Basel III Dodd-Frank	
Sovereign risks		Basel III Dodd-Frank				Basel III

Table 1. Regulatory implementations of the IMF's Policy Solutions.

Dodd-Frank Act

Passed by US Congress on July 21st 2010 (Frank, 2010). On enactment it became immediately effective in law, but was scheduled to be implemented into regulations by federal agencies from the one-year anniversary in July 2011. However, Rep. Barney Frank, D-Mass., said³ on April 27th 2011 that 'no deadline in the law is actually drop-dead'. In reality agencies such as the SEC will take a while longer to implement the initial regulations, and further detailed rule-making will take even longer. The actual implementation deadline appears to be a matter of determination for each agency. Nevertheless, Frank recently opposed a Republican bill attempting to delay derivatives provisions until December 2012. Whatever the ultimate deadlines may be for separate provisions of the Act, as implemented by different agencies, much preparatory work still needs to be done by affected banks in Asia. Broad competitive advantages will reward those who make beneficial improvements now, that are also aligned with the Act's requirements.

The purpose of this legislation: is to improve the transparency, stability and accountability of financial markets within the sphere of US influence. Its main features include: the establishment of new agencies, such as an independent bureau within the US Federal Reserve for the protection of consumer interests relating to certain financial services; a new resolution procedure using 'living wills' for large financial companies in trouble; more stringent regulatory capital requirements (see Overlaps with Basel III); reform in regulations over credit agency roles; securitization reform requiring the retention of more credit risk; planned improvements in derivatives regulation; introduction of the 'Volcker Rule' prohibiting most proprietary trading by banks; changes to corporate governance and compensation practices; and a council of regulators to monitor future financial threats, with special oversight attention going to derivatives markets.

³ "There is no penalty for not meeting the deadline," Mr. Frank said during a webinar sponsored by the National LGBT Bar Association. "There's no gun at their heads. Nobody gets fired."

Examples of new factors in-scope: for determining compliance with Dodd-Frank prohibitions, constraints and obligations include: the role, nationality and up-to-date residency status of individuals and entities providing financial services; their remuneration related to those services; the nationality and up-to-date residency status of clients, transaction counterparties and other intermediaries; types of regulated business transactions conducted, by and with whom; the location, nature and models of the business operations of a firm; sensitivity of product/service offerings to the Act's provisions; relevant interdependencies between product/service offerings, deals, derivatives usage and securitization; credit risks retained from securitization; representations, warranties and other disclosures for securitization; logging of all direct contacts and types of contacts with consumers, plus details of deal offerings, complaints and resolution attempts; identification of all significant disposable assets assigned to the 'living will' of each separate legal entity, with recommendations of how best to dispose of them; risk-based criteria for capital compliance; assigned leverage limits; liquidity requirements and intended sources; concentration risks; alternative methods of credit rating and assessment; proprietary trading containment procedures, systems and logs; stress-testing criteria and testing plans for increased regulatory scope; integration with insurance industry reform, etc.

Where there is an overlap with the requirements of non-US regulatory agencies, issues of jurisdiction will probably take a couple of years to get fully resolved. Meanwhile, a number of follow-up studies are expected to produce detailed rules and implementation guidelines to clarify grey areas, as in the proposed regulatory regime on derivatives for imposing transparency and accountability .

Consequences of the Act: for firms in this region that come within the scope of US influence according to various specified criteria may, for example, obligate them:

- To gather and maintain all information necessary to demonstrate compliance with the Act in federal agency submissions, and when challenged, such as:
 - legal, organizational, corporate and compliance structures of the firm. and the relationships of individuals to them;
 - compliance profiles, classifications and supporting documentation for employees, associates, counterparties and their intermediaries (e.g. executors, trustees, administrators);
 - compliance profiles, classifications and supporting documentation (e.g. incorporation details, operating models, etc) for group entities, such as subsidiaries, branches, agencies, partners, etc;
 - Compliance features of standard products/offerings, and special deals or arrangements, with a history log of related business transactions including derivatives usage or securitization for risk mitigation.
 - business transaction records detailing all participants and the full nature of the business transacted, including asset-level and record-level participation, and the nature and extent of related compensation, risk retention, etc;

- a 'living will' database of disposable assets, with orderly wind-up instructions for each legal entity;
- a full record of RAID logs (risks, assumptions, issues, dependencies) with risk mitigations and issue resolutions related to the Act;
- a full record of compliance activities related to the Act, such as policy communications, responsibilities training, risks and controls assessments, stress-testing, and compliance submissions;
- stress-testing history (scenarios, parameters, plans, results).
- etc.
- To review all outstanding contracts with clients, counterparties and intermediaries to ensure their compliance, and update the terms and conditions of new arrangements;
- To regularly maintain current versions of the enterprise business and operating models, identifying features that are relevant to compliance for scenario analysis and stress testing.
- To implement standard specifications of products/offerings, deals and derivative uses to enable identification of their interdependencies;
- To implement organizational, procedural and systems changes for compliance with the Volker Rule provisions that prohibit proprietary trading, subject to limited exceptions;
- To maintain and periodically submit 'living wills' for use in the event of financial distress or in the wind-up of complex financial firms.
- To establish a closer linkage between compliance policies and rules with the operational behaviour enacted by an enterprise;
- To implement revised risk and compliance management facilities, with competent staff, to ensure the fulfilment of all obligations related to the Act.
- etc.

Some of these obligations may already be satisfied by risk management and compliance practices within Asian banks. Others may not be relevant, or could be avoided by tactical changes to existing practices. The determinant is how much a firm falls within the scope of US influence. A complete list of new obligations for any individual firm can only be compiled after careful analysis of its business and operating models, and a gap analysis between the requirements of Dodd-Frank relevant to those models and that firm's current capabilities, resources and practices.

Overlaps with Basel III: are mainly in the area of capital requirements. The Dodd-Frank Act establishes heightened prudential standards for risk-based capital, leverage, liquidity and contingent capital. However, the introduction of regulations in this area will be delayed by federal agencies until a number of studies return recommendations about the treatment of hybrids and contingent capital. Some allowance has therefore been made in the 'Collins Amendment Provisions' to limit US regulatory discretion over introducing Basel III requirements, which are expected to address international capital adequacy requirements over a similar timescale. Rather than re-inventing similar regulations to the provisions of Basel III, implementations of Dodd-Frank are likely to focus on aspects of capital requirements that remain unregulated after Basel III.

BASEL III

After the normal consultation period, the Basel Committee published Basel III rules and the results of the quantitative impact study (BCBS, 2010a and b) on December 16th and 17th, 2010. All major G-20 financial centres, including centres from the Asian region, have committed to adopting the Basel III Capital Framework by December 2011. Full implementation of the regulation is currently targeted for December 31st, 2019, with a one-year prior phase-in period. It is a global regulatory standard for banks that extends and improves the capital adequacy provisions of Basel II and adds new liquidity and leverage requirements.

The purpose of this regulation: is to increase the quality, consistency and transparency of the capital base of banks; strengthen the risk coverage of capital for certain types of transaction exposures; introduce leverage containment provisions; promote the build-up of capital buffers for procyclicality management; and promote better risk management and provisioning practices.

Examples of new factors in-scope: for determining compliance with Basel III prohibitions, constraints and obligations, beyond those already in-scope for existing Basel II regulations, include: more detailed breakdowns of a bank's capital composition; the risk exposures and cyclicity of a bank's capital; a better understanding of counterparty risk and business concentrations; the identification and measurement of on- and off-balance sheet leverage; and more forward-looking provisioning.

Asian banks are generally better placed to comply with Basel III than banks elsewhere. They often have better quality capital, lower leverage ratios, with more stable funding through longer term liquidity. However they may not have adequate risk management and compliance systems or the skills to credibly demonstrate their compliance to international standards. These things can be developed and acquired within current implementation timescales, but history has shown there is always a tendency to under-estimate the effort and expense involved. As usual, those banks who recognize competitive advantages in making early progress will reap the most rewards.

Consequences of Basel III: will affect firms in this region by requiring them, for example:

- To gather and maintain all information necessary to demonstrate compliance with the regulation when challenged, including:
 - capital composition, change and movement history;
 - counterparty details, risk exposures and concentrations;
 - business cyclicity information;
 - longer term estimations for calculating default probabilities;
 - new leverage measurements;
 - provisioning history;
 - detailed funding history;
 - stress-testing history (scenarios, parameters, results).
- To improve assets and liabilities administration;
- To improve risk calibrations for calculating loss estimates and provisions;

- To increase the scope of credit exposures tracking, such as those arising from transactions in financial instruments;
- To improve counterparty risk exposures tracking and monitoring;
- To build capital buffers according to stress testing results;
- To develop and model longer term scenarios and their effects on capital, funding and liquidity;
- To implement risk and compliance management facilities, with competent staff, to ensure the fulfilment of all obligations related to Basel III.

Using the Modified COSO Framework

It is all too easy to assume that the in-scope factors to be addressed for determining compliance with Dodd-Frank or Basel III are already mostly addressed by Asian banks in their existing responses to international regulations such as: Basel II, FATF Sanctions Screening, Sarbanes-Oxley, etc. Although existing solutions can be re-used or extended, the differences and subtle variations in new regulatory demands are sufficient to cause major disruptions and significant expense if they are underestimated or ignored.

A COSO framework, customized for regional requirements, can be used to coordinate an enterprise response to these demands, reconciling them with existing capabilities and ongoing initiatives. Figure 10 shows how direct operational involvement by risk and compliance management (indicated by red text) can play a key role in this process. By taking a deliverables-driven approach, and using proven techniques from different perspectives to FOCUS on key OBJECTIVES within the priorities of specific STRUCTURES..

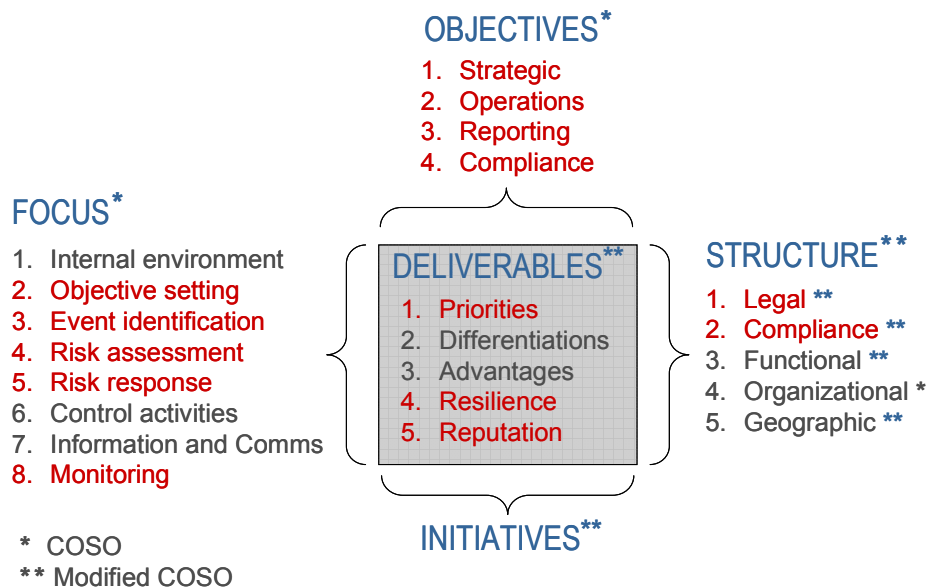


Figure 10: Direct involvement of risk and compliance in COSO.

Various approved ways of doing this can be applied, such as the 'three lines of defence' approach from risk management. Many of these techniques, and the skills necessary to apply them, will already exist in most Asian firms. Perhaps the main weaknesses that need to be overcome are the disconnects between strategic thinking, corporate awareness of macro-trends, and functional responses. If it is done effectively, enterprise risk management and

integrated compliance should be the catalyst for successful risk-based, pre-emptive opportunism. However, while complex challenges must be given their due consideration, they should not be allowed to overwhelm business as usual. Achieving a balance between them should be the aim.

Without a viable way of handling this complexity, results will be difficult and expensive to deliver. By using a customized version of COSO to improve coordination and control, new opportunities can emerge for risk and compliance management to become more directly involved in creating competitive differentiations and advantages (deliverables 2 and 3 in Figure 10) for the whole enterprise. In that expanded role, the goal of operational excellence (see footnote on page 6) becomes a critically important enabler.

Potential Opportunities

Examples of the opportunities that can emerge are briefly explored in this section. However, they may not apply to all Asian banks. The determinant is how much a firm falls within the scope of US influence, as explained previously. A more targeted and comprehensive list would require careful analysis of each individual firm.

A key future differentiator between highly successful banks and the rest will arguably be the way in which their substantial investments in satisfying regulatory obligations are leveraged to also create competitive advantages. Existing compliance solutions previously offered similar advantages, but banks generally failed to realize them. This may be because responses were directed by traditional banking perceptions of risk and compliance having purely defensive roles. Now Dodd-Frank and Basel III offer even more potential, and proactive involvement has become essential. With that in mind, the next sections address the local opportunities in Asia.

Dodd-Frank Act

From a bank's point of view, this may be considered an international legal requirement which currently has little substance in enforceable regulation. Furthermore, it is clearly going to be translated more slowly than anticipated into a few hundred pieces of regulation by a disjointed group of mostly new federal agencies, who are still studying many of the implications of this law. So why should it be treated seriously? Surely it is better to wait until the mist clears, and everyone knows what is expected?

The answer to these questions may be rooted in simple 'early-adopter advantages'. Behind the political and legal rhetoric, an unavoidable global trend is establishing itself: 'banking must achieve unparalleled business and operational excellence to survive'. If regulatory sanctions do not remove what the IMF calls the 'weak tail of banks' (see Figure 2), new competitive pressures and industry restructuring will. Asian banks are at the forefront of this trend for various reasons. Those who are willing to move quickly on positioning themselves for future compliance, even before it becomes mandatory, are likely to secure significant benefits at no additional costs.

Two examples of potential advantages for early adopters of Dodd-Franks are:

Improved customer attraction and retention: A key provision of the Dodd-Frank Act is 'consumer financial protection'. This addresses the operational rules and behaviour of thrift services; the nature of acceptable investment advice and promotional materials; registration of advisors and brokers; clarity in pricing, terms and conditions; full disclosure of risks associated with offerings; etc.

At the same time, customers in the Asian region are demanding more transparency, disclosure and flexibility from their banks. They want to be more personally engaged in managing the risks and rewards of their banking portfolios. Many are also looking for an integrated approach from banks in meeting their financial needs, allowing them access to a range of specialist expertise from one source when appropriate. The idea of a sole relationship manager representing all aspects of a bank is giving way to a bank team of specialists, managed by an account coordinator. This is an approach familiar to private banking, but now being demanded by everyone.. As customer awareness of what they are buying has increased over the past decade, and their portfolios have become more sophisticated, they are beginning to expect banks to satisfy contradictory requirements. So banks must demonstrate they can apply caution and conservatism in managing a customer's basic net worth; while demonstrating skill in satisfying an appetite for leverage and exotic products when it comes to putting disposable income to work. Many of these customer trends have parallels in the Dodd-Frank Act, creating a potential opportunity to develop a new generation of customer/bank interaction offerings that specifically address the Asian region, funded largely by budget allocations for satisfying the excellence demands of planned international regulations. As many customers in the region become more affluent, and an increasing number achieve international mobility, the same banking solutions can still apply wherever their residency or business activities may be.

Enterprise risk and integrated compliance would be required to take a lead role in ensuring that this new generation of customer/bank interaction offerings is indeed fully compliant and enables all necessary risk controls.

Larger wallet/portfolio share of customer business: can be acquired through providing customer access to a bank's risk and compliance management and systems for modelling economic effects on their total net worth. This is probably the most important among growing requirements from customers of Asian banks for access to a range of specialist expertise. Many of the skills and system functions that are used at enterprise level can be applied at portfolio and account level. High-net-worth clients and commercial customers have been getting access to these skills for some time now for making asset management decisions. Now other customer segments are waking up to the advantages. Although portfolio risk management is most in demand, compliance management is also finding opportunities in areas such as overseas investment, capital movement, currency trading, tax law and trade sanctions regulations.

Dodd-Frank calls for investor protection reforms, securitization reforms, credit rating agency reform amendments, and various consumer protection

provisions that will all have impacts on customer portfolio risks. With careful leveraging of compliance costs, they can be combined with existing demands to help lower risk exposures both for banks and their customers.

Basel III

The following example of potential advantages for early adopters of Basel III builds on existing risk and compliance management content from Basel II:

Lower customer risks: through Involvement in managing customer risk exposures. Customer portfolio risk modelling can be offered by banks by allowing access to risk and compliance management and systems, using Basel II techniques with improvements from Basel III. These include better risk calibration techniques, methods for identifying new risk concentrations, more diverse exposure assessments, more accurate loss estimate calculations, and improved scenario-based stress testing.

Practical Initiatives

A Suggested Top Ten

This section distils a list of ten practical initiatives out of the comments and suggestions of previous sections for Asian banks, to achieve competitive advantages through excellence in enterprise risk and integrated compliance. Relative priorities and implementation sequences will vary according to each bank's needs, and many unanswered questions will undoubtedly remain. As stated in the Objectives section of this document, the intention has been to offer an 'outline' of practical responses. Each initiative description is brief and high-level, and the list is certainly not exhaustive. Some initiatives will not apply to all banks, and in some cases broad infrastructural facilities will already be in place. But the hope is that new ideas about potential next steps are generated for individual Asian bank.

1. **A general review of existing risk and compliance management capabilities.**
2. **Enterprise gap analysis for Dodd-Frank and Basel III readiness.**
3. **Compliance mandated bank re-organization feasibility study** (e.g. to address Volker-Rule requirements, etc).
4. **Reorientation of risk and compliance capabilities** to support new and changed product/service offerings and provisions.
5. **Consolidating separate risk and compliance management teams** into one enterprise risk and integrated compliance organization.
6. **Modified COSO framework development** and initiatives support.
7. **Risk-based customer support development** (i.e. for providing customer access to risk and compliance management and systems).
8. **New risk-mitigation opportunities research** and development.
9. **Risk and compliance leadership in Operational Excellence** initiatives.
10. **Risk and compliance skills transfer** – interim management, mentoring.

An example timeline for implementing these initiatives is shown in Figure 11. This makes many assumptions that may not apply to an individual bank, but nevertheless puts key initiatives into context with current Dodd-Frank and Basel III deadlines.

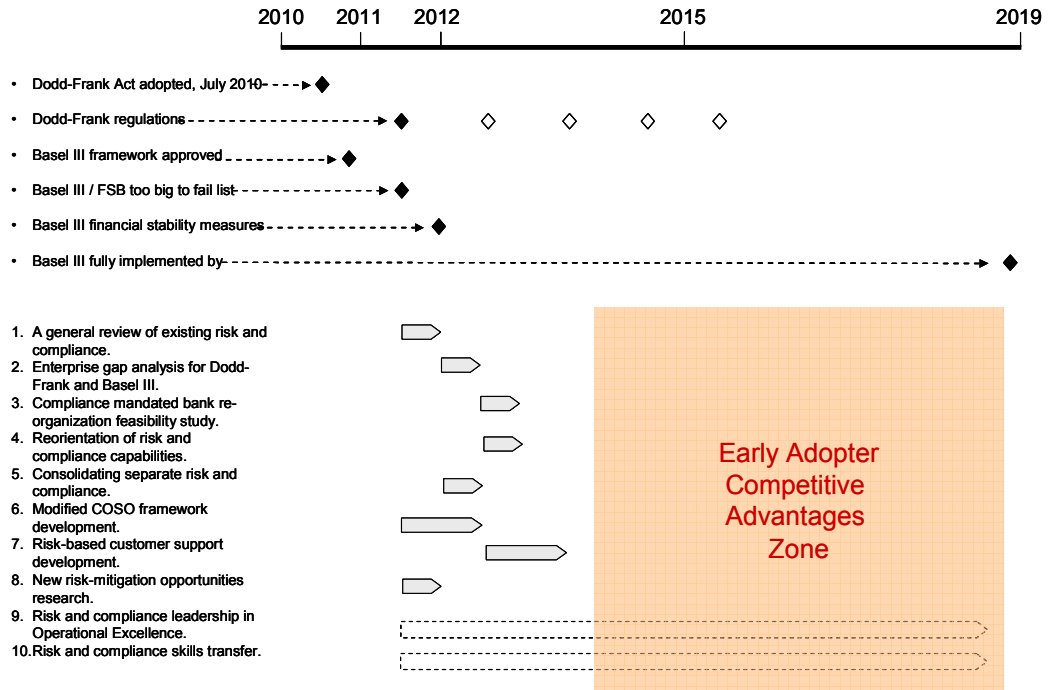


Figure 11. Initiatives Implementation Timeline.

The Response Framework

Finally, by documenting intentions into a response framework, as shown in Figure 12, a bank can begin to coordinate its responses to these regulatory and business demands, and reconcile them with existing capabilities and ongoing initiatives.

A key feature of this approach is the direct involvement of enterprise risk and integrated compliance in all deliverables production (red text in the DELIVERABLES box in Figure 12). Without that commitment there can only be a continuation of piecemeal attempts to address enterprise-level risk and compliance issues with partial solutions.

Achieving operational excellence along the way should not be considered a by-product of 'doing stuff well'. It is an initiative in its own right (number 9 in the top ten list). Risk and compliance management are expected to take a leading role in this initiative because it reflects regulatory priorities. To get an acceptable balance between risk and reward, risk management should be defining what risks are acceptable, monitoring enterprise prudence, and working with compliance to demonstrate this to regulators. On the reward side, this white paper suggests that risk and compliance management also have many opportunities to promote significant competitive advantages.

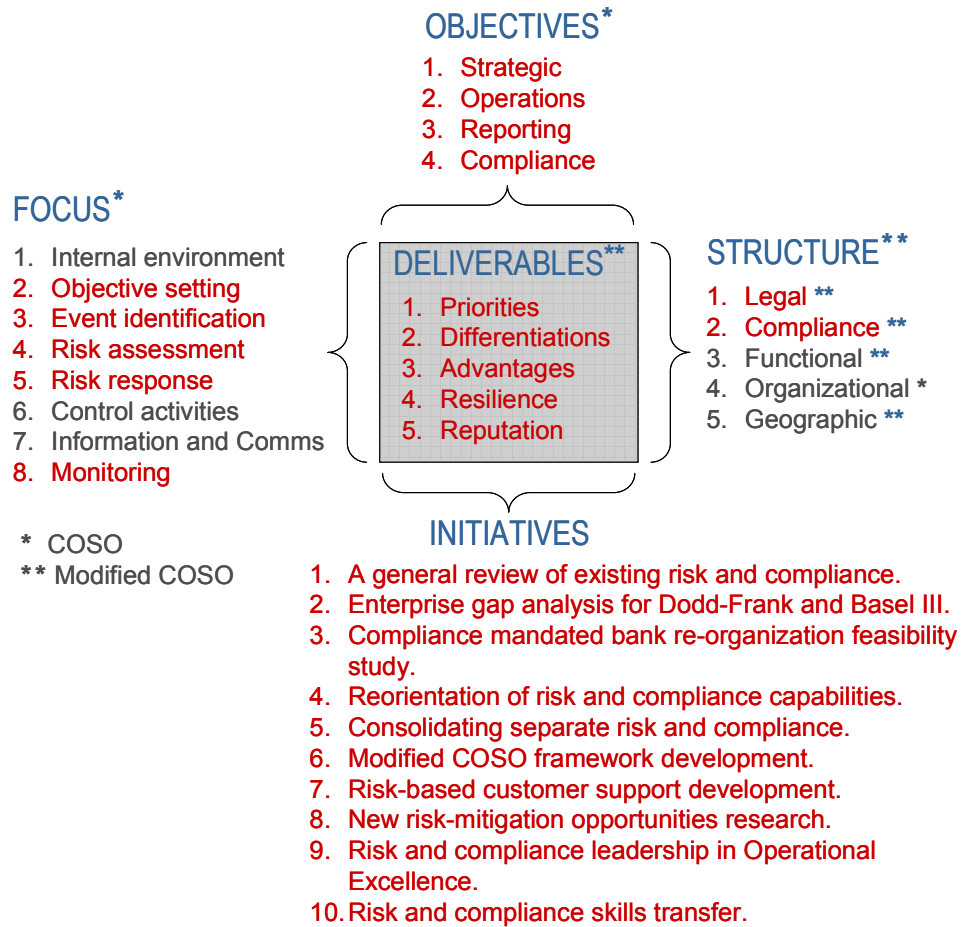


Figure 12. Example response initiatives in modified COSO

Conclusions

Hopefully some useful considerations have been raised to support the key message summarized in the Objectives section of this white-paper, that:

Sustainable competitive advantages can be created for firms in the Asian region, without compromising local resilience to global economic turbulence - **by extending the operational scope of risk and compliance management functions** along a firm's financial services value chain - **to help achieve excellence** through an integrated programme of new and existing initiatives, **focused on the local practicalities** of global challenges and opportunities.

Only time will show if the Asian region can maintain its financial stability advantages over other regions in the global financial services industry, One thing is certain however, new challenges are emerging that require a re-think of current priorities at the very least. If pressures for change are seen to be growing, this white-paper suggests that pre-emptive change can have major advantages over re-active change.

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