TITLE:

Regulatory Landscape and Challenges

AUTHOR:
Adrian Orr
Chief Executive

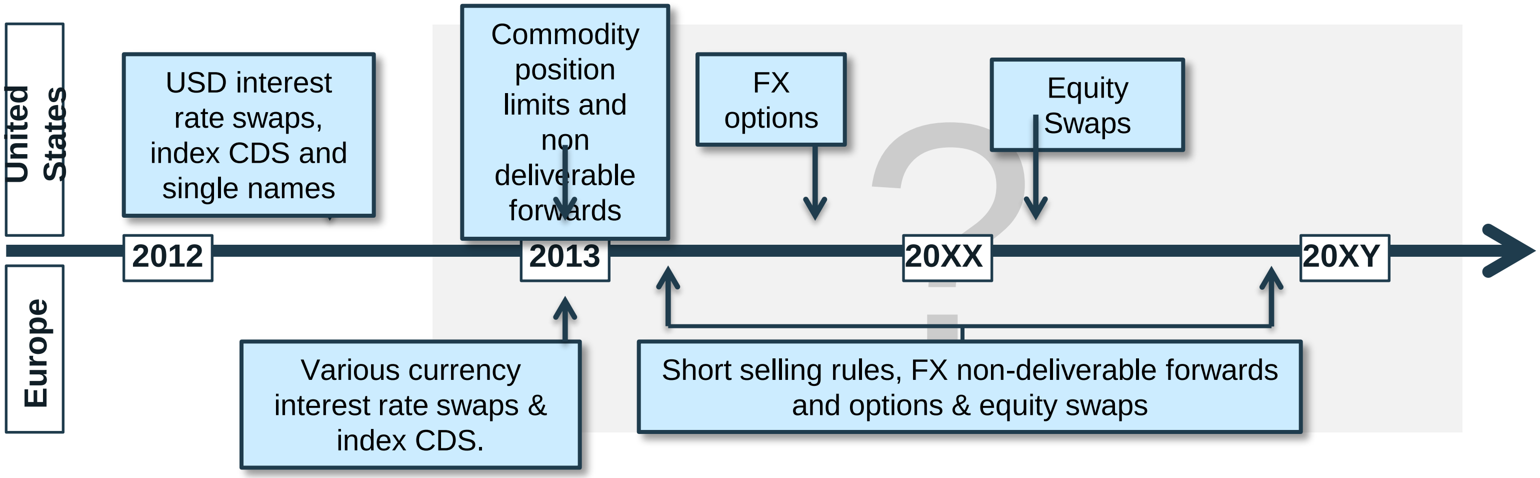
EVENT | PRESENTATION:
September 2012

Overview

- Significant regulatory and legislative reform globally: banking, insurance, financial instruments. In part stemming rom G20 commitment 2009
- Reforms aimed to reduce systemic risk, increase transparency, improve consumer choice making e.g., US (Dodd-Frank - OTC, Volcker Rule), European Market Infrastructure (EMIR); Basle III; and Alternative Investment Fund Managers Direction (AIFMD) and so on.
- Effectiveness will be unclear and the "law of unintended consequences" exists
- Key impacts include:
  - "Rules-based" not "principles based" – moral hazard;
  - Raises the demand (and price) for high quality capital and raises the returns to 'capital transformation';
  - New entities bring new counterparty risk and operational complexity;
  - Availability and definition of acceptable collateral associated with new margin requirements;
  - Clearinghouse margin requirements based on security risk profile versus counterparty credit ratings;
  - Decrease in market liquidity and potential hedging efficiency due to the Volcker Rule;
  - Commodity position limits may result in investment portfolio constraints
  - Market impacts arising from lack of global coordination
- There are also opportunities to be created for long-term investors: improved liquidity premium; regulatory arbitrage opportunities; insurance and underwriting roles
- Potential role for coordinated response to regulators on the implementation of these issues from SWFs

Time line – Over The Counter Derivatives

- Compliance to be phased in across the interest rate, credit, commodity, foreign exchange and equity asset classes sequentially.



- Initial and variation margin will be posted to central clearing houses via participant's clearing broker. Once transactions settle, counterparties will face the credit of the clearing house.
- Risks that there is a lack of harmonization of rules; CCP credit risks; margin price variation; price and availability of high quality credit; regulatory harmonisation

Issues

- Implementation timelines are diverging
- Regulatory 'reach' and exemptions yet to be clarified
- Specific rules may impact investment programs e.g., limits imposed on commodity contracts
- Central Clearing margin calculation methodologies and acceptable collateral has not been determined - (broadly G7 sovereign debt which may especially impact funds which tend to hold a large percentage of assets in equities).
- Counterparty exposure shifting from global financial institutions to a few nationally regulated clearing houses - creates a new set of credit concerns;
- Different approaches to Trade Repositories - from locally built to the adoption of existing facilities (may result in reconciliation challenges, and ability to track international derivative flows).
- Execution costs will rise and be recouped through transaction costs on buy-side participants.

Changes potentially translate into

- Collateral Requirements:
  - Central Counterparties are permitted to accept only “highly liquid” assets as collateral and uncertainty exists as to how this will be interpreted.
  - Market participants could face collateral upgrade charges in addition to increased cash balances required to provide for market fluctuations.

- Margin Requirements without Differentiation for Creditworthiness – The legislation does not differentiate between the credit worthiness of market participants (all firms are treated equally by the clearing house regardless of credit quality).

- Operational complexities – execution platform; affirmation platform; connection to repositories

- Portfolio bifurcation of collateral management – Futures; CSA; OTC

Changes potentially translate into

- Volcker Rule:
  - The reduction in market participants may widen bid-offer spreads
  - Volatility in fixed income markets more pronounced with reduced liquidity
- Commodity Position Limits:
  - May be subject to speculative limits
- Investment programs incorporating commodity futures contracts constrained
- International coordination necessary for regulatory bodies e.g., how non-US market participants will be affected by the Volcker Rule and Dodd Frank.