The emerging regulatory requirements – including structural reform, conduct, governance and the possible emergence of ‘Basel 4’ – are game changing. The banking industry’s existing business models are being substantially reshaped.

Executive Summary

The relentless march of the regulatory reform agenda continues. The ‘more (and more) of everything’ series of regulatory initiatives seems unlikely to abate and will continue to reshape radically the banking sector. While the change is perhaps most marked in Europe and the US, we are seeing knock-on effects on ASPAC, first because European and US institutions are reshaping their activities in the region, and second because these changes in the major markets are having an impact on the regulatory philosophy in many ASPAC jurisdictions too, particularly in jurisdictions which are now members of the Basel Committee, Financial Stability Board (FSB) and G20, and subject to the peer review processes applied by the Basel Committee and FSB, together with IMF Financial Sector Assessment Program (FSAP). An issue this creates, however, is that regulators in ASPAC now have less licence than before to modify international regulatory initiatives in ways that are appropriate to the region.

The waves of regulation are swirling around banks more rapidly than many can manage. This raises the prospect that there will be more casualties before the financial crisis is over. Successful banks will be those who can keep ahead of the storm by meeting the demands of customers, investors and regulators.

The financial stability landscape

The first set of challenges for banks, which this report focuses on, is to meet the current and prospective regulatory requirements on capital, liquidity and recovery and resolution planning (RRP). Banks caught in the headlines of Basel 3 implementation may miss the wider picture here, as Basel 3 transforms potentially into a ‘Basel 4’ as a result of tougher requirements on the leverage ratio, risk-weighted assets and stress testing.

The report then considers four areas where a combination of regulatory and other pressures is forcing banks to reform their strategy, business and operating models, governance and culture. This will have significant impacts on the customers of banks.

Structure

Regulatory requirements will force major structural change, including the split of global entities into a patchwork of smaller locally or separately regulated subsidiaries. Many banks have already begun to revise their legal entity structures and to reduce and restructure their balance sheets. This, combined with the impact of ‘Basel 4’, may significantly increase the cost of doing business.

Addressing the myriad regulatory and legal, compliance, capital, liquidity, funding, tax and governance considerations is a complex, multi-dimensional issue. But, in addition, banks must also consider the operational complexities. These complexities are often not considered until the implementation stage, but they can themselves preclude any number of options, or can increase the cost or lapsed time such that some options become unworkable.

Conduct, markets and culture

Much banking practice historically has been ‘product push’ – focused on the desire to sell rather than a more thoughtful view of what would best suit the needs of the customer. This has contributed in retail banking to the various mis-selling disasters of recent years particularly in Western markets but also, to some extent, in the ASPAC region, and in wholesale markets to the significant and widespread market abuse issues.

Reputationally, this has been a disaster for the banking industry. Financially, the issue has been focused on specific jurisdictions – but however this is measured, it is a depressing picture.

Retail banks want to become customer centric, but are finding it hard to deliver this given legacy systems, culture and the inertia in the industry. Wholesale banks are still getting to grips with what client centricity might mean (given the past treatment of customers for many business lines as counterparties or sophisticated investors). Regulators are looking for radical changes in banks' behaviours.

The regulatory bar has been raised significantly, not only in terms of the outcomes to be achieved but also in terms of the clear articulation of what conduct risk means to a bank, how it is a core part of the strategy, and how clearly articulated and implemented the governance, controls and key indicators are from the boardroom down to front line product design, manufacturing and distribution.

Only really significant change to the DNA, culture and values of banks can rebuild the organisation to meet the needs of investors, customers and regulators. This is reflected in the change programmes of many banks, but this sort of change is much harder than (even) sorting out the core operations.

It is critical that this change is underpinned by a dramatic shift in culture, through tone from the top, policies, hiring practices, incentive structures, embedding values and demonstrating consequences for behaviours which are no longer acceptable. This is a huge boardroom challenge. For many banks only radical surgery will satisfy all these stakeholders – few banks today have a complete answer.

Data and reporting

Banks face three major challenges around data management. They need to hold and use the right data to get much closer to their customers. They have to meet the wide-ranging and significant increases in demands from regulators and others for reporting and disclosures. And they need to respond to supervisory concerns that banks do not have the right data, systems and IT architecture to enable them to understand, aggregate and disaggregate, and manage their risks effectively.

With home and host supervisors often looking for different aggregations of data, the need to monitor risk at a consolidated level, and the data demands relating to resolution planning and to stress-testing, banks very much have their hands full on data issues.

Meanwhile, banks also need to address the new and unforeseeable risks in data privacy and cybercrime, conflicting national laws and the impact of retrospective investigations in an environment where vast amounts of data are indefinitely available.

Key to these challenges are increasing the maturity of data analytics capabilities; a clear understanding of the ownership, roles and responsibilities for data management (including retention and rationalisation); a clear plan to attack core data quality issues; and the implementation of more flexible technology solutions with greater sharing/re-use and better handling of unstructured data.

Governance and risk

The financial crisis itself, and the problems and challenges discussed above, point to a need to upgrade significantly the governance and risk management of banks. Much work is already underway on this, but much more needs to be done. As banks get to grips with their business strategy, risk appetite, risk culture and management they will need quite different management information which only significant investments in core and critical systems, as well as emerging analytic technologies, will provide. They also need to consider how to form a group-wide view of risk in addition to looking at business line and geographical/regional risks.

OTC derivative reforms

The ongoing OTC derivative reforms are having a significant impact on banks in the region. So far, the most challenging aspect of the OTC derivative reforms for many banks has been responding to the extra-territorial aspects of the US Dodd-Frank and European Market Infrastructure Regulation (EMIR). Major jurisdictions in the region have made significant progress in implementing their OTC derivative reforms and we expect to see more requirements come into force in the next year. A number of uncertainties remain and the end-state for OTC derivative markets in ASPAC has yet to be reached.

BANKS NEED TO RESPOND TO MULTIPLE PRESSURES

CUSTOMERS

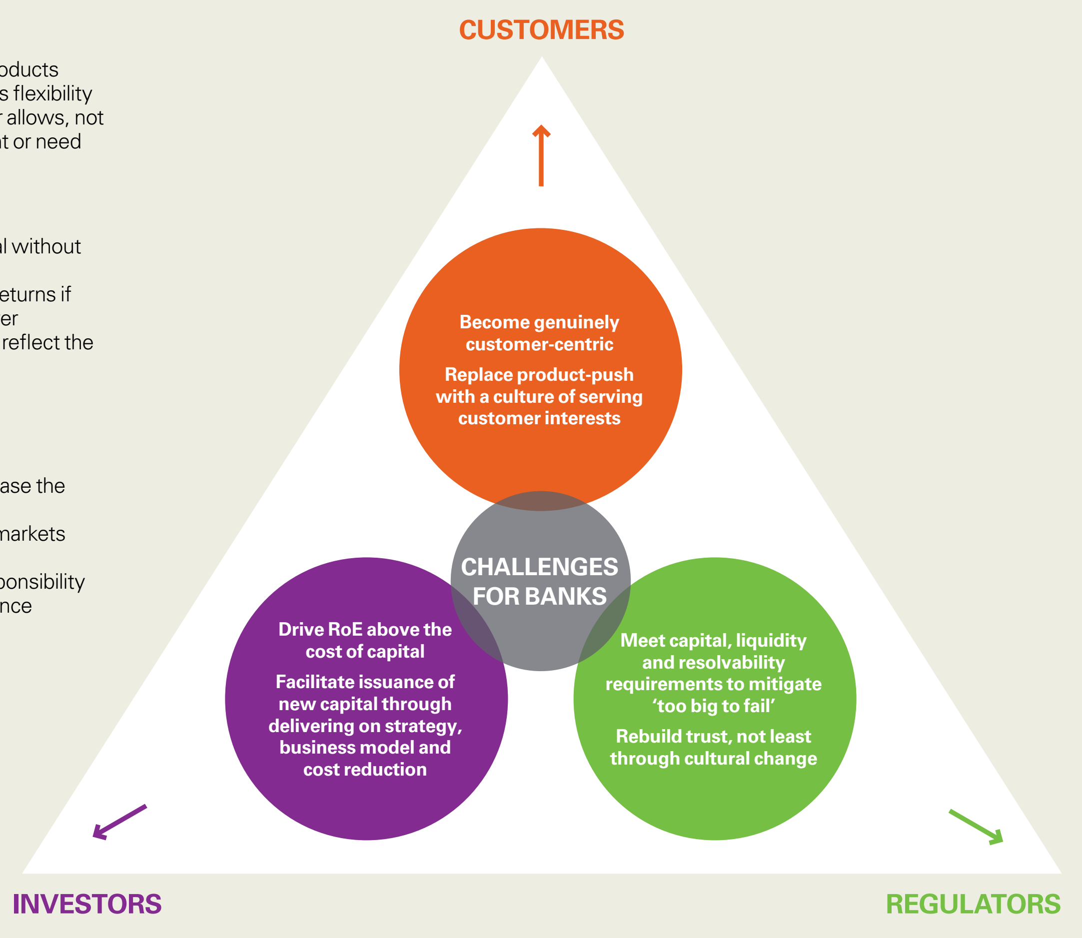
- Fewer, more expensive products
- More transparency but less flexibility
- Offered what the regulator allows, not necessarily what they want or need

INVESTORS

- Will not put up more capital without adequate returns
- Prepared to accept lower returns if risk is correspondingly lower
- Debt coupons will need to reflect the threat of bail in

REGULATORS

- Regulatory demands increase the cost of capital
- Mistrust of banks, capital markets and shadow banking
- Emphasis on personal responsibility and improved risk governance



Source: KPMG International, January 2014