

FINANCIAL SERVICES

# Evolving Banking Regulation EMA Edition

Is the end in sight?  
February 2014

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## ABOUT THIS REPORT

This report is part of a regional series developed by KPMG's network of regulatory experts. The insights are based on discussion with our member firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region.

For other regional reports, please contact [fsregulation@kpmg.co.uk](mailto:fsregulation@kpmg.co.uk) or see [www.kpmg.com/regulatorychallenges](http://www.kpmg.com/regulatorychallenges)

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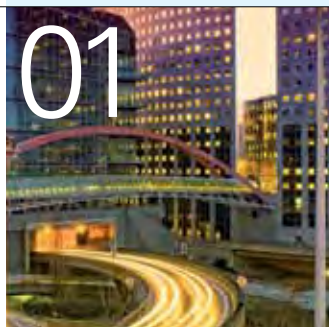
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Welcome to this year's Evolving Banking Regulation for the Europe, Middle East and Africa (EMA) region.

Banks are generally moving from the evaluation of regulatory initiatives to implementation, albeit at different speeds and from different starting points. That is why, in this year's report, we focus on four key areas where regulation, combined with other pressures, is forcing banks to make changes. These are structure; conduct and culture; data and reporting; and risk governance.

# Half way there?



**Jeremy Anderson**  
Chairman Global Financial Services

Looking back over the last 12 months or so, the regulatory reform agenda has notched up some significant achievements. These include the implementation of Basel 3 in Europe; laying the groundwork to reduce systemic risk through measures relating to the safety and soundness of both banks and market infrastructure and to the effective resolution of failing banks; advancing the wholesale and retail conduct regimes; and setting out the supervisory stall for assessing risk governance, risk culture and risk data.

But as we look forward it becomes clear that the regulatory glass is only half full, some six and a half years after the financial crisis began in the summer of 2007. New regulatory initiatives continue to emerge, with no apparent reduction in frequency. Many banks and their regulators have achieved less than they should have done over the last six and a half years. And, particularly in Europe, there remains concern that regulatory reforms are hindering the ability and willingness of banks to support economic recovery.

In my discussions with senior bankers and regulators, some serious challenges keep rising to the surface, and seem a long way from being resolved.

## **Cross-border resolution**

For all the progress made on recovery and resolution planning, and on developing the 'bail-in' tool, the question of how to resolve effectively a cross-border bank remains unanswered. Indeed, the more that the

resolution authorities in some major financial centres (US, UK and Switzerland) press ahead with their preferred version of how resolution and bail-in would operate, the more that 'host' countries take a step back and consider how to protect their local interests in the event of the resolution of a major international bank.

I fear that the end result here will be a further retreat into localisation and balkanisation, with local requirements on the bail-in capacity of the local operations of foreign banks being added to local requirements on capital, liquidity, funding, governance and even subsidiarisation. The senior bankers I speak to, and increasingly their major corporate clients, see this localisation of regulatory requirements as a serious threat to operating a sustainable global business model without adding costs or reducing services to global clients.

## **More regulation to come = continuing uncertainty**

The continuing debates on the leverage ratio, internal models, stress tests, and simplicity versus complexity are leaving both bankers and regulators very uncertain about where the regulatory reform agenda will come to rest. This makes it difficult for banks to plan effectively.

But it is clear from the direction of travel that there will be further pressures on banks to raise more capital to support their business activities, and to exit, re-price or restructure their business lines. The debates also call into question whether banks





will ever be able – or be allowed by their regulators – to tell their own story to their investors, customers and other stakeholders about what risks they take and how they manage these risks.

Another source of great uncertainty, at least for the next 12 months, will be the Comprehensive Assessment to be undertaken by the European Central Bank before it takes on direct supervisory responsibility in November 2014 for the 120 or so major banks in the European banking union.

### **Culture**

However necessary the MiFID 2 and EMIR-driven focus of the conduct and market infrastructure agenda in Europe has been, it is being overtaken by the impact of an alarmingly wide range of retail and wholesale market misdemeanours. This in turn is shifting the focus from detailed conduct rules to the culture and behaviour of banks, with a clear read-across to greater personal accountability, the development and measurement of key performance

indicators for culture and behaviour, and further pressure on remuneration and incentive structures.

### **Data**

Banks face a myriad of issues around data quality and management. Data demands are growing all the time, but ensuring these data are fit for purpose remains difficult given the fragmented systems and processes through which the data flow. Good data are all about providing the basis for product design, customer service, risk management and business decisions, but many banks remain seriously constrained by their legacy IT and data systems.

Meanwhile, bank supervisors are becoming increasingly frustrated by the implications of this for the effectiveness of banks' risk management. Supervisory intensity in this area is already on an upwards trajectory, and this can safely be predicted to continue over the next few years. This will hasten progress by the banks in improving their data and risk

management, but in a world of limited budgets this may hold back investment on more strategic and commercial projects.

### **Future of banking**

I commented last year on how KPMG member firms saw the possible future of banking. Banks are restructuring in favour of locally capitalised, funded and client-driven businesses, centred on regional hubs. They are striving to introduce a real client focus at the heart of their businesses, and the right culture and people to deliver this. And they are seeking to rebuild a relationship of trust with their customers, investors, regulators and other stakeholders. These developments are a continuing journey, and those banks that take a bold, direct and simple approach are likely to emerge as the industry leaders in the future.

I hope you enjoy reading this report, and that it provides useful insights which you can apply to your business. ■

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 will in large part have to be discarded. There are likely to be losers. The winners are likely to have been relentless in how they have faced up to and implemented the change required.

# Executive Summary

**T**he 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, in particular in Europe.

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. Banks caught in the headlights 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 European Central Bank will undertake its Comprehensive Assessment of major banks in the European banking union, which may identify further capital deficiencies. Resolution planning will require banks to issue bail-inable long-term debt and increase their funding costs. All of this implies further deleveraging or capital raising.

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 radical 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’, will dramatically 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 led in retail banking to the various mis-selling disasters of recent years, 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).

Supervisors in Europe 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 exponential 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.

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 radically different management information which only significant investments in core and critical systems, as well as emerging analytic technologies, will provide. ■

## 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

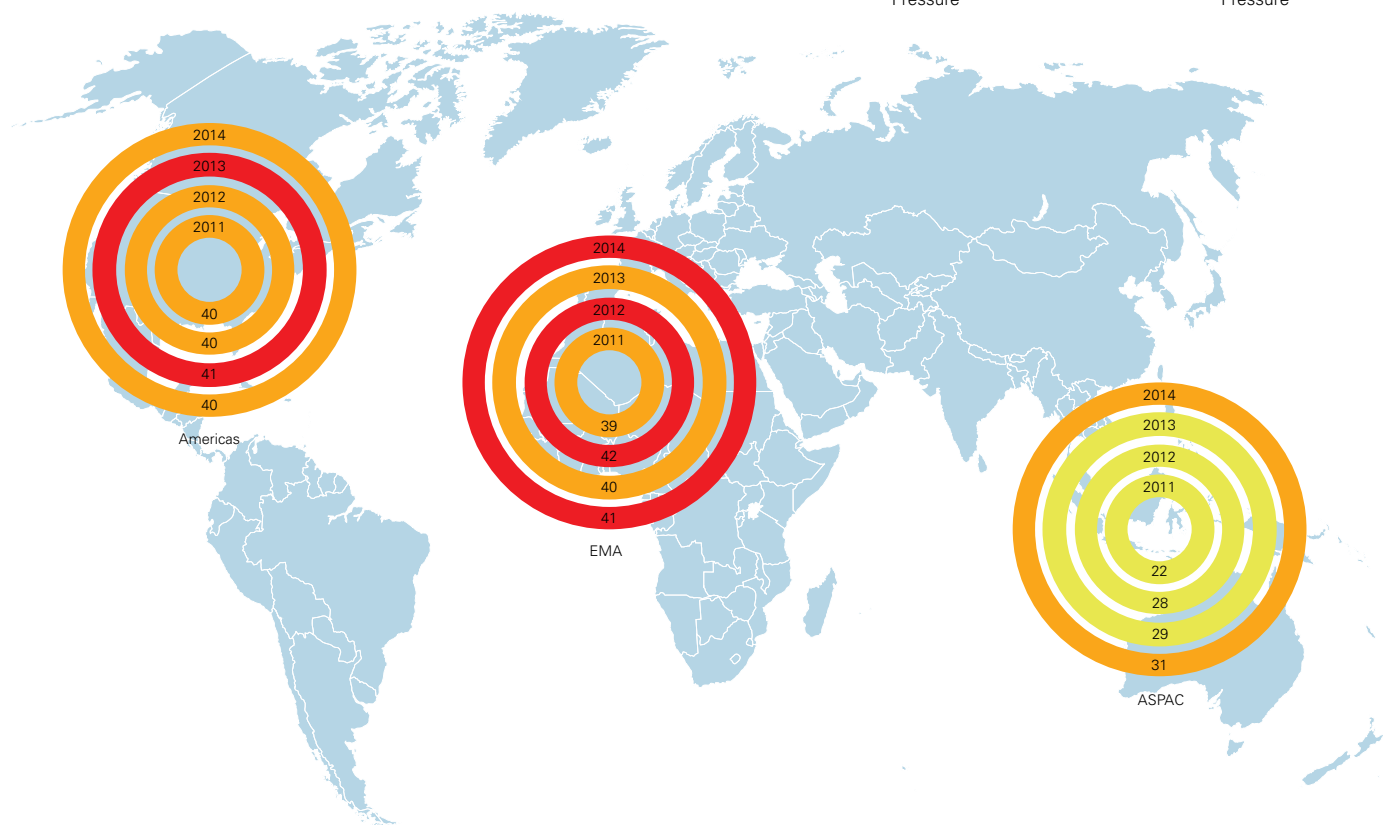
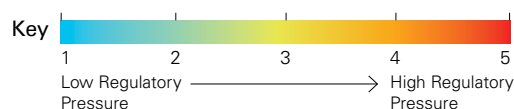
- Regulatory demands increase the cost of capital
- Mistrust of banks, capital markets and shadow banking
- Emphasis on personal responsibility and improved risk governance



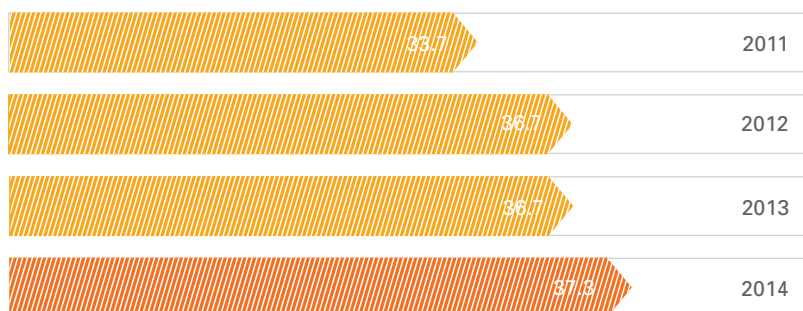
Source: KPMG International, January 2014

# Regulatory Pressure Index

## REGULATORY CHANGE – REGIONAL DIVERGENCES



## THE GLOBAL PRESSURE CONTINUES TO GROW



**Note:** The regional numbers are the sum of the scores in each region across the ten individual areas of regulatory pressure. The global pressure index is the (unweighted) sum of the scores for each region, divided by three.



## THE EVOLVING REGULATORY AGENDA

Overall, our regulatory pressure index stands slightly higher than a year ago.

Six and a half years into the financial crisis the overall regulatory pressure on banks shows little sign of abating. The implementation of the initial wave of regulatory reforms is coinciding with the continuing emergence of new regulatory initiatives, such as leverage, structural separation and localised supervision.

In some areas, pressure has eased slightly since 2013 where implementation is in progress:

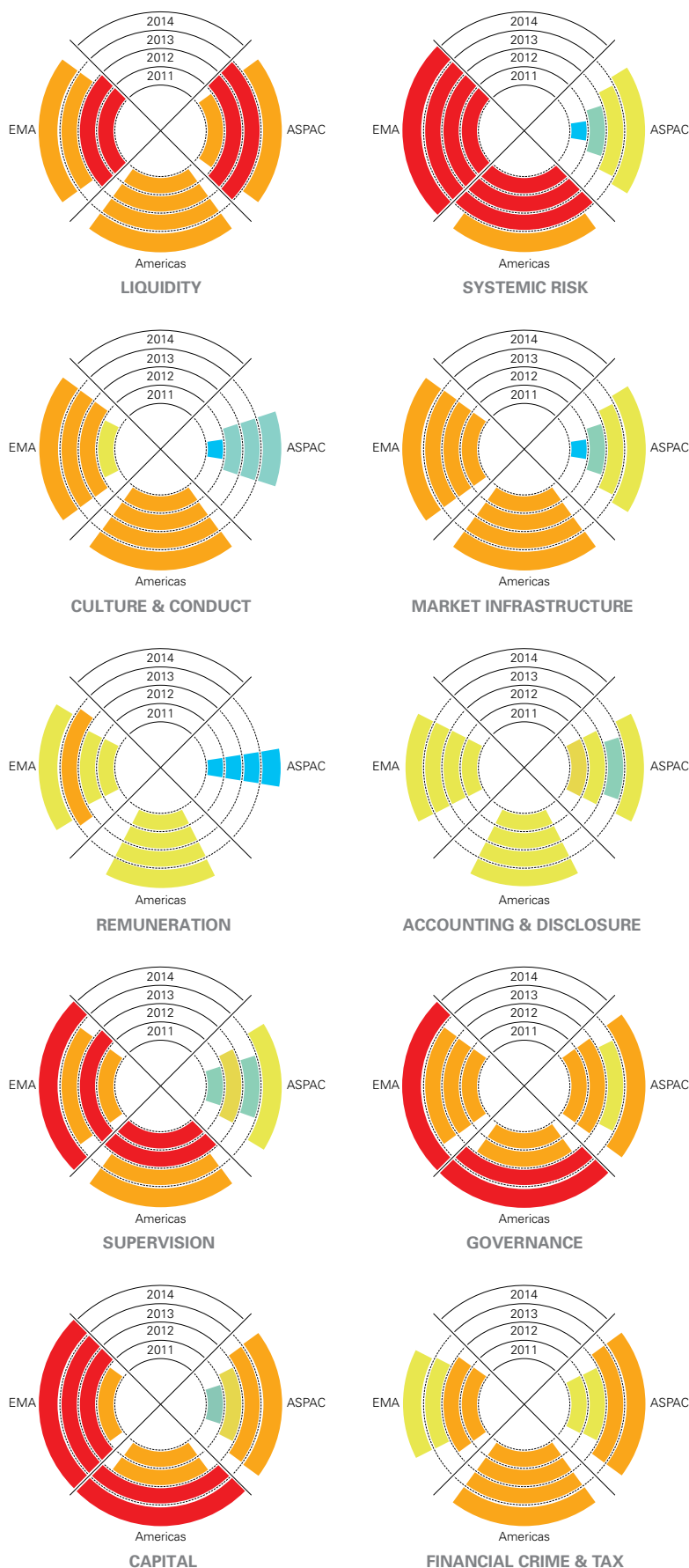
- **Liquidity** – reflecting the relaxation to the Liquidity Coverage Ratio and the balance sheet adjustments made by the banks themselves;
- **Systemic risk** – reflecting the progress made on recovery and resolution planning in the US and some other countries;
- **Remuneration** – where earlier dire predictions on banks' responses to regulatory restrictions have proved largely unfounded; and
- **Market infrastructure** – where adjustment to the requirements on the clearing, trading and reporting of derivatives is under way.

However, the flow of new regulatory initiatives has increased the pressures on banks, including:

- **Capital** – the prospect of 'Basel 4' emerging through a combination of a higher leverage ratio and a much tougher approach to the weighting of banks' credit and market risk exposures;
- **Systemic risk** – the prospect of structural separation through the EU's proposals to implement the Liikanen recommendations;
- **Supervision** – the increasingly intensive approach of supervisors across the globe, and the shift of supervisory responsibilities in the European banking union to the European Central Bank;
- **Governance** – the series of FSB and Basel Committee initiatives on risk governance, and the wide-ranging new requirements on data reporting;
- **Culture and conduct** – where large banks in particular face heightened pressure to improve their culture and conduct.

Regionally, the clearest trend over the last four years is the steadily increasing pressure, from a low base, on banks in the Asia Pacific region, as regulatory requirements mount in areas such as capital, systemic risk, market infrastructure, and the intensity of supervision. Overall, however, the pressures still remain lower in Asia Pacific than in the Americas and the EMA region. ■

## AREAS OF REGULATORY PRESSURE



## THE FINANCIAL STABILITY LANDSCAPE

### In this chapter

- Basel 3
- Liquidity
- Leverage ratio
- Risk-weighted assets
- Basel 4
- ECB Comprehensive Assessment
- Recovery and resolution

# 01 The Financial Stability Landscape

Six years after the beginning of the global financial crisis, 2013 was a pivotal year for regulatory reform in Europe. The 'CRD4' package was finalised, for phased implementation from 1 January 2014; the Bank Recovery and Resolution Directive and the 'MiFID 2' package reached their final stages; the implementation of new clearing rules under EMIR began; and euro area integration took a step forward through agreement on the Single Supervision Mechanism and the European Central Bank's plans to conduct a Comprehensive Assessment.

Meanwhile, at a global level, the Basel Committee published a key paper on risk data aggregation and reporting, and the Financial Stability Board published a series of papers on risk governance and continued to focus on systemic institutions and on progress in implementing regulatory reforms.

The regulatory reforms intended to improve the resilience of banks and markets, to make banks resolvable without recourse to public funds, and to increase the supervisory intensity on systemically important banks, have finally begun to take shape.

Equally, however, even if the direction of travel is all too clear, the list of unfinished business remains long, casting a pall of uncertainty over the detail of the regulatory reform agenda. This is particularly true of the leverage ratio and the growing prospect of regulatory restrictions on banks' use of internal model-based approaches for the calculation of capital requirements for credit and market risks. In addition, the Basel 3 minimum capital requirements are being superseded by stress scenario-based requirements. A significant shift to a tougher 'Basel 4' may yet emerge from the finalisation of these areas of unfinished business.

It is therefore important for banks to consider all of these moving parts, together with the elements that are already more or less firmly in place. Addressing issues in isolation will not be effective.









## THE FINANCIAL STABILITY LANDSCAPE

### OTHER BASEL 3 RELATED UNCERTAINTIES

#### → Large exposures

The Basel Committee consulted in March 2013 on the measurement of, and limits on, banks' large exposures. The main proposed changes were to:

- Tighten the reporting (by moving to a 5 percent of CET1 threshold) and 'hard' limits on large exposures (leaving the upper limit at 25 percent of capital, but again narrowing the definition of capital to CET1 capital);
- Define more precisely how exposures should be measured, so the requirements can be applied more consistently across countries; and
- Impose tougher limits on the large exposures of systemically important banks.

#### → Central counterparties

In a series of papers issued in June 2013, the Basel Committee, the International Organisation of Securities Commissions and the Committee on Payment and Settlement Systems outlined revised capital adequacy standards for exposures to central clearing counterparties (CCPs). They also proposed standards for counterparty credit risk (where the Basel Committee is consulting on consolidating the two existing non-modelled approaches, namely the current exposure method and standardised method), and the capital and other support required by CCPs, including for their recovery and orderly resolution.

#### → Pillar 2

It remains unclear how 'Pillar 2' capital requirements will adjust as a result of the implementation of Basel 3. In principle, the tougher minimum Pillar 1 requirements should mean that banks are subject to smaller Pillar 2 capital add-ons, since there are fewer risks that are not adequately captured by the Pillar 1 minimum requirements.

#### → Securitisation

The Basel Committee issued a second consultative paper on securitisation in December 2013. This proposes higher and more risk-sensitive capital requirements for securitisations, with a minimum 15 percent risk weighting; reduced 'cliff effects' in capital requirements as the quality of the underlying assets deteriorates; less mechanistic reliance on external credit ratings; and greater consistency with the treatment of credit risk more generally. Banks will be able to choose from three approaches to the calculation of capital requirements – an internal ratings-based approach, an external ratings-based approach, and a standardised approach.

### Basel 3

Basel 3 will be implemented in the EU from 1 January 2014, through the 'CRD 4 package' – the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD). The CRR largely copies out the core elements of Basel 3 – tighter definitions of capital, greater emphasis on higher quality capital (in particular CET1 capital: equity and retained earnings), higher minimum capital ratios, higher risk weightings on counterparty exposures, the counter-cyclical capital buffer, the leverage ratio, the Liquidity Coverage Ratio and the Net Stable Funding Ratio.

In addition, the CRD 4 package provides for:

- The imposition of capital surcharges on global and domestic systemically important banks. The Basel Committee has announced prospective capital surcharges for 29 G-SIBs, to be phased in from 2016, and attention is now turning to the designation of banks of national systemic importance (D-SIBs);
- An additional systemic risk buffer that member states can apply to all, or a subset, of banks to cover medium-term structural or systemic risks. The UK is expected to apply a systemic risk buffer of 3 percent on at least the major UK banks, bringing the minimum CET1 capital ratio up to 10 percent; and
- The introduction by member states or the Commission of more stringent large exposure limits, sector-specific risk weightings, liquidity and disclosure requirements on all, or a subset of, banks.

But many uncertainties remain here, the most important of which relate to liquidity, the leverage ratio, and risk-weighted assets.

**But many uncertainties remain here, the most important of which relate to liquidity, the leverage ratio, and risk-weighted assets.**

## Liquidity

The Basel Committee signed off on a revised approach to the Liquidity Coverage Ratio (LCR) – the amount of high quality liquid assets that a bank should hold to cover stressed cash outflows over a 30-day period – in January 2013. This makes it easier for banks to meet the LCR than under the original proposals, by expanding the definition of high quality liquid assets to include equities, residential mortgage-backed securities and lower rated corporate securities; reducing the assumed outflow rates on some types of liability; and phasing in the minimum LCR requirement from 60 percent in 2015 to 100 percent from 2019.

In the EU, the CRR imposes a shorter transition period, with the minimum LCR requirement jumping from 80 percent in 2017 to reach 100 percent in 2018, while also requiring banks to meet the equivalent of an LCR-type requirement from 1 January 2014, by holding sufficient liquid assets to cover potential net cash outflows under stressed conditions. In addition, the European Banking Authority (EBA) has issued guidelines on the appropriate run-off assumptions for different types of retail deposit, and made recommendations on the definition of high quality liquid assets. Meanwhile, in the UK the Financial Policy Committee has asked the Prudential Regulation Authority (PRA) to consider whether additional liquidity requirements are needed on systemic grounds to supplement the LCR.

Work continues on the Net Stable Funding Ratio (NSFR) – essentially a requirement on a bank to hold sufficient stable deposits (retail and long-term wholesale deposits) to fund its long-term lending. Banks are required to report their NSFR positions during an observation period running until 2016, after which the NSFR is due to be finalised and to become a binding requirement from 1 January 2018. The Basel Committee relaxed the calculation of the NSFR in January 2014, and has so far resisted adopting simpler measures focused more directly on short-term wholesale funding – for example as in the proposal by US Federal Reserve Governor Tarullo that banks that are substantially dependent on wholesale funding should hold additional capital.

## Leverage ratio

Banks are already reporting their leverage ratios to their supervisors as part of the ‘parallel run’ period due to continue until January 2017. Once finalised, the minimum leverage ratio would then become a binding ‘Pillar 1’ requirement from January 2018. Meanwhile, banks will have to publish their leverage ratios from the date of publication of their first set of financial statements on or after 1 January 2015, using a common disclosure template and including a reconciliation statement to their published financial statements.

The Basel Committee will continue to assess the appropriateness of a 3 percent minimum leverage ratio based on total tier 1 capital, and to consider the impact of using either CET1 capital or total regulatory capital as the capital measure.

Meanwhile, the Basel Committee has relaxed somewhat the initially tough proposals it consulted on in July 2013 on how exposures will be measured. The amendments announced in January 2014 will allow some netting of securities financing transactions with the same counterparty; avoid the double-counting of derivatives cleared through central counterparties; and apply less punitive credit conversion factors to off-balance sheet exposures.

Some commentators continue to argue for a minimum leverage ratio higher than 3 percent, with some suggesting a minimum ratio of at least 6 percent. They argue that:

- If the 3 percent minimum leverage ratio is calibrated against the minimum Basel 3 risk weighted capital ratios, then it ought at least to be set proportionately higher for systemically important banks that are required to meet higher capital ratios, and to adjust in line with counter-cyclical capital requirements;
- In a world characterised by uncertainty (where it is not possible to attribute precise probabilities to outcomes), it may be better for policy makers to follow a simple rule rather than trying to match real world complexities; and
- Simple rules (using leverage ratios and market capitalisations) would have predicted better which banks ran into difficulty during the financial crisis.

**A higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a ‘front stop’ rather than a ‘back stop’ requirement.**

Some countries are already moving ahead of the 3 percent minimum leverage ratio. In the US the Federal Reserve Board is proposing a minimum leverage ratio of 5 percent for systemically important banks and 6 percent for retail banks owned by a systemically important bank, to be applied from 2018 (although this is not directly comparable with the 3 percent Basel 3 figure, because the applicable accounting standards in the US allow more netting of off-balance sheet exposures).

In Switzerland the largest banks will be required to meet a minimum leverage ratio against total capital of around 4.3 percent by 2019. And in the UK the authorities are reviewing the case for using the leverage ratio as a macro-prudential tool and have already imposed stress tests that use CET1 capital rather than total tier 1 capital as the capital measure for the leverage ratio.

A higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a ‘front stop’ rather than a ‘back stop’ requirement. This could have perverse consequences. Banks could be incentivised to hold riskier assets; the capital cost of funding a portfolio of low risk-weighted assets and off-balance sheet exposures, including mortgage lending and sovereign debt, would increase; and focusing on a non risk-sensitive measure would remove an incentive (regulatory permission for a bank to use internal models to calculate risk weights) that can be used to drive improved risk management by banks.



## THE FINANCIAL STABILITY LANDSCAPE

### The Basel Committee has already formulated proposals to restrict the extent to which model-based approaches can reduce the capital required against market risk.

#### Risk-weighted assets

Basel 3 focused mostly on the quality and quantity of capital, and the new minimum leverage and liquidity ratios, while maintaining the internal model-based approaches to credit, market and operational risk. More recently, however, the Basel Committee and other regulatory authorities have been focusing on the risk weightings generated by banks using their own internal models.

The main regulatory concerns here are that:

- Some banks have been too aggressive in the use of internal model-based approaches to drive down risk weightings;
- Some banks are reducing their capital requirements through 'risk weighting optimisation', even if some of this reflects no more than cleaning up data and the planned rolling out of risk modelling to a broader set of exposures;
- Risk weightings generated by internal models are too complex and opaque;
- A prolonged period of low interest rates is enabling borrowers to avoid default, and thereby generating misleadingly low probability of default estimates; and
- There is limited transparency – and therefore limited scope for relying on market discipline – in this area.

A series of Basel Committee and European Banking Authority (EBA) reports during 2013 on the risk weightings of banks' banking book and trading book assets have revealed wide divergences in risk weights. Underlying differences in the risk composition of banks' assets are found to explain between half and three-quarters of the variations in risk weightings across banks for banking book assets, but only half of the variation for trading book assets. The remaining variation is driven by two main factors – diversity in the models used by banks, and diversity in supervisory guidelines and practices.

In response to these findings, the Basel Committee has already formulated proposals to restrict the extent to which model-based approaches can reduce the capital required against market risk (see box) and to increase consistency across banks. Similar proposals can be expected on internal-based model approaches to credit risk, including:

- Limiting the flexibility of the advanced approaches, for example by setting 'benchmarks' for risk parameters (which supervisors could use as a reference point for assessing firms' internal model estimates), or setting more explicit constraints such as floors (or even fixed values) for certain parameters. This would limit the extent to which a bank could benefit from using model-based calculations of capital requirements;
- The imposition of minimum parameters to reflect stressed conditions;
- Additional policy guidance to constrain differences in bank and supervisory practices; and
- Enhanced Pillar 3 public disclosures by banks to improve understanding of how banks calculate risk weighted exposures using internal models.





## TOUGHER TRADING BOOK REGIME MOVES CLOSER

The Basel Committee has published two consultative documents on a fundamental review of the trading book, in May 2012 and October 2013. The most recent paper narrowed down the range of options to a single set of proposals which will form the basis for a Quantitative Impact Study. The main proposals cover:

- A simpler and tougher boundary between the trading book and the banking book;
- Calibrating both internal models-based approaches and the standardised approach for market risk against stressed market conditions, and changing the basis of calculation from value at risk (VaR) to Expected Shortfall (ES) measures. This will increase capital charges under both approaches;
- Extending the assumed time horizons for liquidating exposures in stressed market conditions;
- A tougher approach to allowing benefits from hedging, based on whether a hedge is likely to be effective during periods of market stress;
- Restricting the calculation of capital charges for credit risk on securitisations in the trading book to the revised standardised approach; and
- Requiring banks using internal models to disclose both their internal models-based capital charges (disaggregated by type of capital charge and by trading desk) and the capital charges that would have been required under the standardised approach.

→ **The Basel Committee is still considering whether to restrict the benefits of internal models-based approaches in the trading book, for example by applying a floor or a surcharge to limit the extent to which model-based approaches can deliver lower regulatory requirements than under the standardised approach.**

**The overall effect of these proposals, if implemented, would be to reduce significantly the benefit available to banks through the use of internal models, and increase banks' costs as a result of both restrictions on capital benefits and increased operational costs. The proposals will also increase the capital required under the standardised approach.**

These reduced benefits and increased costs will drive banks to reassess the pricing and continuation of product lines, with implications for banks' customers. More generally, together with regulatory requirements for the central clearing of derivatives and market and regulatory driven increases in collateral, these proposals will fundamentally change the dynamics and economics of trading.

## THE FINANCIAL STABILITY LANDSCAPE

For more information on Basel 4

### Basel 4 – Emerging from the mist?

<http://www.kpmg.com/global/en/issuesandinsights/articlespublications/regulatory-challenges/pages/emerging-from-the-mist.aspx>



### 'Basel 4'

KPMG has argued that a 'Basel 4' may already be emerging, even before Basel 3 is fully implemented. Key elements of this may include:

- A higher leverage ratio, and higher risk-weighted assets, as discussed above;
- The gold-plated implementation of Basel 3 in some countries, including the US and the UK; and
- Requiring banks to meet minimum capital ratios after the potential impact of severe stress events, and therefore to hold significant additional capital buffers, contrary to the intention in Basel 3 that the capital conservation buffer and any counter-cyclical capital buffer would be the cushion to absorb a shock.

In a related development, the Basel Committee published in July 2013 a discussion paper on balancing risk sensitivity, simplicity and comparability. This noted both the advantages of greater simplicity

and comparability, and the potential disadvantages of overly simplistic capital requirements. The paper also set out some ideas to improve simplicity and comparability:

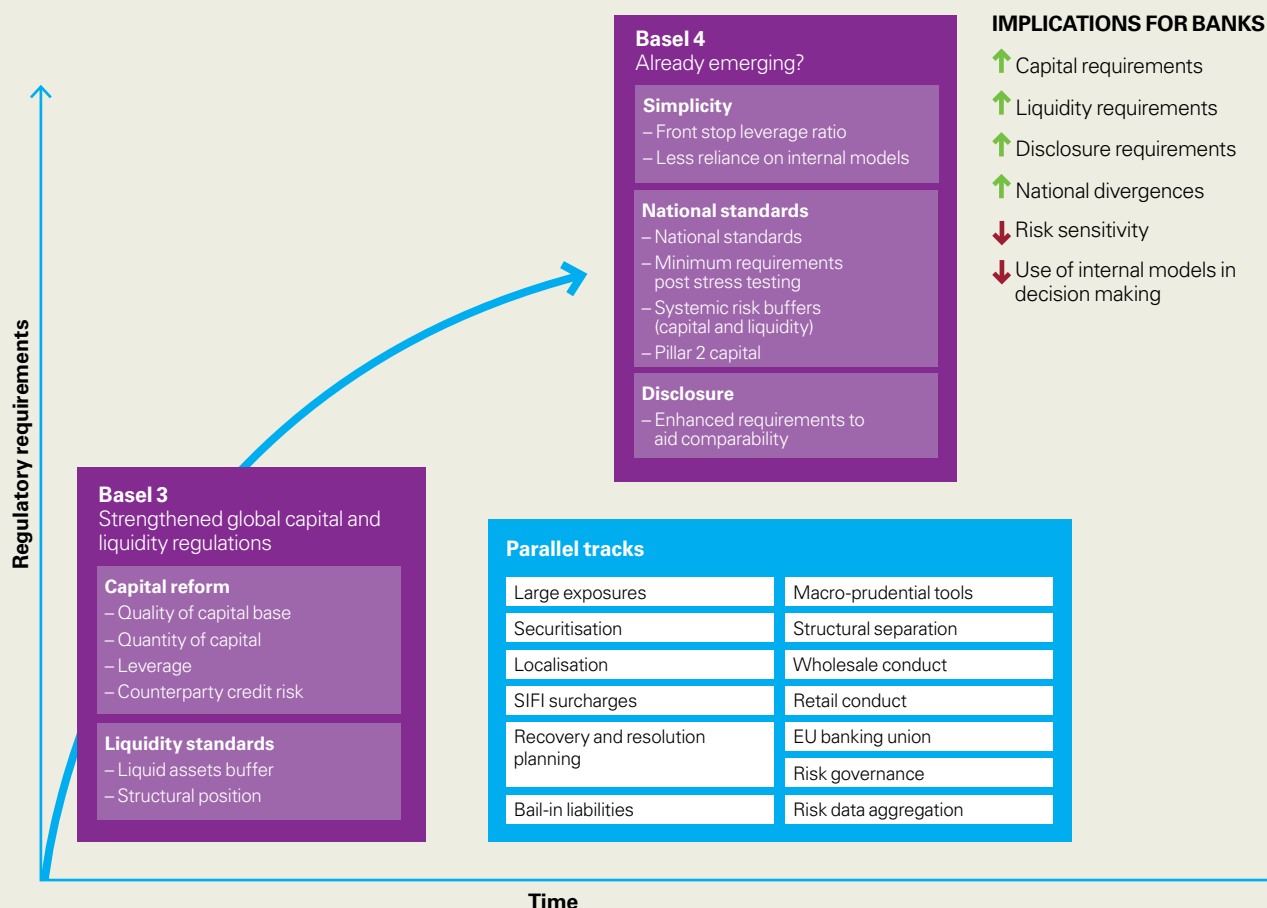
- Recognising simplicity as an additional objective against which new Basel Committee proposals should be judged;
- Mitigating the consequences of complexity in model-based approaches by adding floors to constrain the results of modelled capital requirements; introducing a more refined 'use test'; and limiting national discretions in the area of internal models;
- Strengthening the leverage ratio by replicating elements of the risk-based capital requirements – adding 'buffers' to the leverage ratio and imposing tougher leverage requirements on systemically important banks;
- Enhancing disclosure by requiring banks to disclose the results of applying their models to hypothetical portfolios; to disclose both modelled and standardised calculations; and to publish additional metrics that might be useful to investors,

such as capital ratios using market values of equity, risk measures based on equity volatility, revenue-based leverage ratios, historical profit volatility, and the ratio of non-performing assets to total assets; and

- More fundamental longer-term reforms such as relying on a tangible equity leverage ratio; abandoning the use of internal models; imposing capital requirements against income volatility; or reducing risk and complexity by limiting the use of complex and innovative financial instruments and restricting non-traditional banking business.

Reflecting these themes, the paper also discussed a re-balancing of the three pillars to place more emphasis on Pillar 2 and Pillar 3. Pillar 1 minimum requirements could then be simplified, while shifting some of the complexity – including internal modelling approaches – into Pillar 2, and while enabling shareholders, bondholders and market analysts to exercise a more informed view based on enhanced disclosures by banks.

## EMERGENCE OF BASEL 4





**Since one key rationale for making the ECB responsible for banking supervision across the banking union was to move away from the perceived weaknesses of some national supervisors, it would be reasonable to expect the ECB to adopt a generally tough and intensive supervisory approach.**

### **European Banking Union and Comprehensive Assessment**

In November 2014 the European Central Bank (ECB) will become the primary banking supervisor of more than 120 'significant' banks in the European banking union (the euro area countries and any other member states that opt in to banking union), and will oversee the supervision (which will remain, at least initially, with national supervisory authorities) of all the other banks in the banking union.

Ahead of taking on its new responsibilities in November 2014, the ECB will undertake a Comprehensive Assessment of the euro area banking system (see box), focusing on 124 banks in 18 member states that constitute around 85 percent of euro area bank assets. Even if this exercise improves confidence in banks over the medium term, it will increase uncertainty in the shorter term.

There is also uncertainty about the supervisory, regulatory and macro-prudential stance that the ECB will take once it assumes its supervisory responsibilities from November 2014. Since one key rationale for making the ECB responsible for banking supervision across the banking union was to move away from the perceived weaknesses of some national supervisors, it would be reasonable to expect the ECB to adopt a generally tough and intensive supervisory approach. The ECB may also accelerate – at least within the banking union – moves towards greater consistency in how banks calibrate their internal risk models; in the definition and treatment of non-performing exposures, provisioning and forbearance; and in the use of macro-prudential tools.

## **THE ECB'S COMPREHENSIVE ASSESSMENT**

The ECB's Comprehensive Assessment will comprise three elements, which may require some banks to address capital shortfalls:

### **Supervisory risk assessment**

The ECB and the national supervisory authorities are jointly developing a new risk assessment system to capture a bank's risk profile (including leverage, liquidity, funding, business model and profitability), its position relative to its peers, and its vulnerability to shocks. The significant banks are being required to complete a template to feed into this risk assessment.

### **Asset quality review (AQR)**

Between February and June/July 2014 the ECB will examine the asset side of the balance sheets of the 124 banks. This will be based on harmonised definitions of non-performing exposures and forbearance. The potential coverage of this review is very wide, including all risk types and exposures, both on and off-balance sheet. The review of each bank will be risk-based, focusing on (i) a minimum level of coverage and (ii) the most risky or non-transparent exposures of the bank, as identified by the national supervisor and reviewed and challenged by the ECB.

For these bank-specific exposures, the AQR will include data integrity validation; a sampling of portfolios and on-site file

reviews; an assessment of the adequacy of banks' asset and collateral valuations, provisioning, and the classification of non-performing loans; and an adjustment of credit and market risk-weighted assets (although the AQR will not include a full assessment of the internal models used by banks to calculate risk-weighted assets).

### **Stress test**

The ECB and the EBA will cooperate closely on the next EU-wide (not just banking union) stress test, to be conducted mostly in the third quarter of 2014. This will build on the AQR by providing a forward-looking view of banks' capacity to absorb shocks under stressed scenarios (including stressed conditions for sovereign debt securities).

The results of the AQR and the baseline stress test will be judged against an 8 percent common equity tier 1 capital ratio (the Basel 3 and CRR minimum of 7 percent, plus a 1 percent add-on for systemically important banks). However, for the AQR this will be based on the capital definition as at 1 January 2014, while for the stress test this will be based on the definition valid at the end of the horizon used for the stress test (so probably end-2016 and therefore close to a 'fully loaded' version of Basel 3 and the CRR).

The ECB has also stated that the leverage ratio will provide supplementary

information for assessing the outcomes, but it remains unclear how this will operate in practice.

### **Capital shortfalls**

The ECB is encouraging banks to adjust in advance where necessary, through recapitalisation, asset sales and other measures. If, at the end of the Comprehensive Assessment, further adjustment is required and the bank has a viable business model then the ECB would expect corrective action to be taken over an appropriate period, using private sources of capital wherever possible. Public sector support should be a last resort, and would be subject to stringent State Aid rules.

In addition to the uncertainty surrounding the outcomes, which will not be fully dispelled until October or November 2014, banks will face a difficult period between the completion of the AQR in June or July 2014 and the completion of the stress test some four or five months later. The ECB does not intend to make a public announcement of the results of the AQR separately from the results of the overall Comprehensive Assessment, but banks that know their own AQR results may be under market and disclosure rules pressure to publish their AQR position.

## THE FINANCIAL STABILITY LANDSCAPE

### Recovery and resolution

The legislation and regulatory guidance necessary to underpin recovery and resolution planning has been strengthened considerably over the last year. The FSB's 'Key Attributes for Effective Resolution', published in November 2011, have been carried forward in EU and national legislation, while the FSB's Guidance papers on recovery and resolution planning (July 2013) form the basis for more detailed planning for the recovery or resolution of a major international bank.

Meanwhile, the bail-in tool – which passes the cost of meeting losses and of recapitalising a failing bank on to creditors by writing down the value of their claims or converting them into equity – has been gaining momentum. It has been used as one element in the resolution and restructuring of banks in Cyprus, Denmark and the Netherlands. Under the revised EU temporary State Aid rules for banks, which took effect from 1 August 2013, shareholders and junior (subordinated) debt holders will be expected to meet losses and recapitalisation requirements before any public funds are injected to support a failing bank. Switzerland has already introduced bail-in powers through legislation, and in the UK the bail-in tool is being added to the Special Resolution Regime, which was originally introduced in 2009.

In Europe, the Bank Recovery and Resolution Directive (BRRD) is expected to enter into force on 1 January 2016, two years earlier than first proposed. The Directive covers:

- The preparation by banks of recovery plans, and the review of these plans by national supervisors;
- The provision of information by banks to national resolution authorities, to enable these authorities to construct resolution plans;
- Granting powers to national authorities to require banks to change their legal and operational structures – and even their business models – to enhance recovery and resolution;
- Legislative changes to give national authorities the full range of resolution tools;
- The basis on which the bail-in tool will be operated (see box); and
- Establishing national resolution funds, to raise at least 1 percent (around €75 billion across the EU) of covered deposits by 2025.

Within the European banking union, it is proposed that the BRRD should be supplemented by a Single Resolution Mechanism (SRM). The two main elements of the SRM are to establish a single resolution board and a single resolution fund for the banking union, although the details of these remain to be finalised. The intention is that the decision to place a failing bank into resolution would be taken by a single resolution board, comprising national resolution authorities and ECB executives, but (under current proposals) subject to the European Commission (and possibly relevant national governments) being able to object to the decision – in which case the decision would be taken by the European Council. Meanwhile, the single fund (of €50–55 billion for the banking union) will eventually be fully mutualised, but would operate on a compartmentalised basis for the first ten years, so any member state in the banking union that wanted to use this fund would have to rely (to a declining extent over the ten years) on its own national 'compartment' as well (to an increasing extent) as on the overall fund.

Little progress has been made on creating a single deposit guarantee scheme for the banking union, even though that was announced as a key element of banking union in July 2012.

For banks, the main recovery and resolution planning issues fall under four main areas.

#### **Banks will need to develop their recovery plans and to provide information to the resolution authorities.**

The European Banking Authority (EBA) has already begun to develop detailed guidance in these areas, and in the UK the PRA issued revised guidance in December 2013. Banks may then be required to make changes to improve the credibility and effectiveness of recovery and resolution plans, including higher capital and more robust funding to underpin recovery, and changes to business activities and legal entity and operational structures to facilitate resolution.

#### **Banks will be required to pre-fund a resolution fund and/or Deposit Guarantee Scheme, and to provide additional funding if a fund or scheme proves to be inadequate to meet the demands on it.**

#### **Banks will need to issue at least the minimum required amounts of bail-in-able liabilities.**



**The bail-in tool – which passes the cost of meeting losses and of recapitalising a failing bank on to creditors by writing down the value of their claims or converting them into equity – has been gaining momentum.**



This may include requirements to issue specific types of long-term debt that would be bailed-in after equity and other regulatory capital, but before other senior unsecured and uninsured creditors. This will result in higher funding costs for banks, not least because the possibility of bail-in will replace the reliance of investors (and unsecured and uninsured depositors) on the prospect of failing banks receiving government support.

**Some national resolution authorities – in particular those in Switzerland, the UK and the US – are expecting most international banking groups to follow a ‘single point of entry’ approach.**

This would require loss-absorbing capacity to be issued at parent (holding company) level, and then down-streamed to the operating

subsidiaries of the group, so that in a resolution the conversion or writing-down of this capacity could both recapitalise the group and enable it to meet losses in operating subsidiaries. This would also buy time for the authorities during the initial stages of a resolution, making it less necessary to make immediate use of other resolution tools that would break up or sell off the business of the group. Instead, a recapitalised group could be preserved, albeit under new ownership and new management.

However, it remains unclear how the cross-border resolution of a major international banking group would operate in practice. Host national authorities may seek to maximise the capital and bail-inable debt available to them locally, which could turn a single point of entry approach into multiple points of entry.

For investors, one key aspect of the bail-in proposals has been the need for greater certainty in how the bail-in tool will be used in practice. This includes the conditions under which the resolution trigger will be activated (the point of non-viability of a bank); the choice of resolution tools by a national authority; the order in which different types of eligible liability would be bailed in; the choice of a national authority between writing down the value of liabilities and converting them into equity; and the extent to which a national authority might make use of a resolution fund or even government support as an alternative to the bailing-in of liabilities. The BRRD does not remove these uncertainties, and they will have an impact on the pricing of banks’ long-term debt issuance in particular. ■

## BANK RECOVERY AND RESOLUTION DIRECTIVE: THE BAIL-IN TOOL

The BRRD sets out in detail how the bail-in tool would operate as part of a resolution. There are four key elements:

→ Some liabilities are excluded from being eligible for bail-in:

- Covered (insured) deposits;
- Secured liabilities, including covered bonds;
- Liabilities arising from the holding of client money or client assets;
- Liabilities with a remaining maturity of less than seven days to payment systems;
- Interbank liabilities with an original maturity of less than seven days (to avoid disorderly runs ahead of a possible resolution);
- Liabilities to employees, such as fixed salary and pension benefits; and
- Commercial claims relating to goods and services critical for the daily functioning of the institution.

→ The BRRD introduces an expectation that eligible liabilities will be bailed-in in the following order:

- Equity;
- Other regulatory capital;
- Ordinary unsecured creditors (including bondholders) and large corporate depositors;
- Individuals and SMEs; and
- Deposit Guarantee Schemes (but leaving insured depositors themselves fully protected, so the cost here would fall on other banks that fund the Scheme).

→ National resolution authorities would have the discretion to exclude, or partially exclude, liabilities from bail-in on a discretionary basis if they cannot be bailed in within a reasonable time; to ensure the continuity of critical functions; to avoid contagion; or to avoid value destruction that would increase the losses borne by other creditors.

National resolution authorities would be able to compensate for the discretionary exclusion of some liabilities by passing these losses on to other creditors, provided no creditor is made worse off than under normal insolvency proceedings, or through a contribution by the national (or single) resolution fund – assuming that there are sufficient funds available to follow either of these alternative routes.

However, the use of a resolution fund could only be as a backstop, after losses equal to at least 8 percent of total liabilities had been imposed on a bank’s shareholders and creditors; and where the contribution of the resolution fund would be capped at 5 percent of the total liabilities of the failing bank.

In extraordinary circumstances, where other resolution tools (including bail in) are deemed to be insufficient to preserve financial stability, government support may be provided through injections of new capital or taking a bank into temporary public ownership.

→ National resolution authorities will have the discretion to set minimum requirements for the total of regulatory capital, other subordinated debt, and senior debt with a remaining maturity of at least one year, expressed as a percentage of a bank’s total liabilities. This requirement can be set on a case-by-case basis for each bank, taking into account the size, risk, resolvability, systemic impact and business model of each bank. A review clause in the Directive would enable the Commission to propose from end-2016 a harmonised set of minimum requirement applicable to different types of bank.

*'The most rigid structures, the most impervious to change, will collapse first.'*

Eckart Tolle

## 02 Structure

**Banks face multiple pressures to reconsider their strategies, business models and operating structures. These range from structural separation requirements to bail-in liabilities, and from capital requirements to liquidity.**

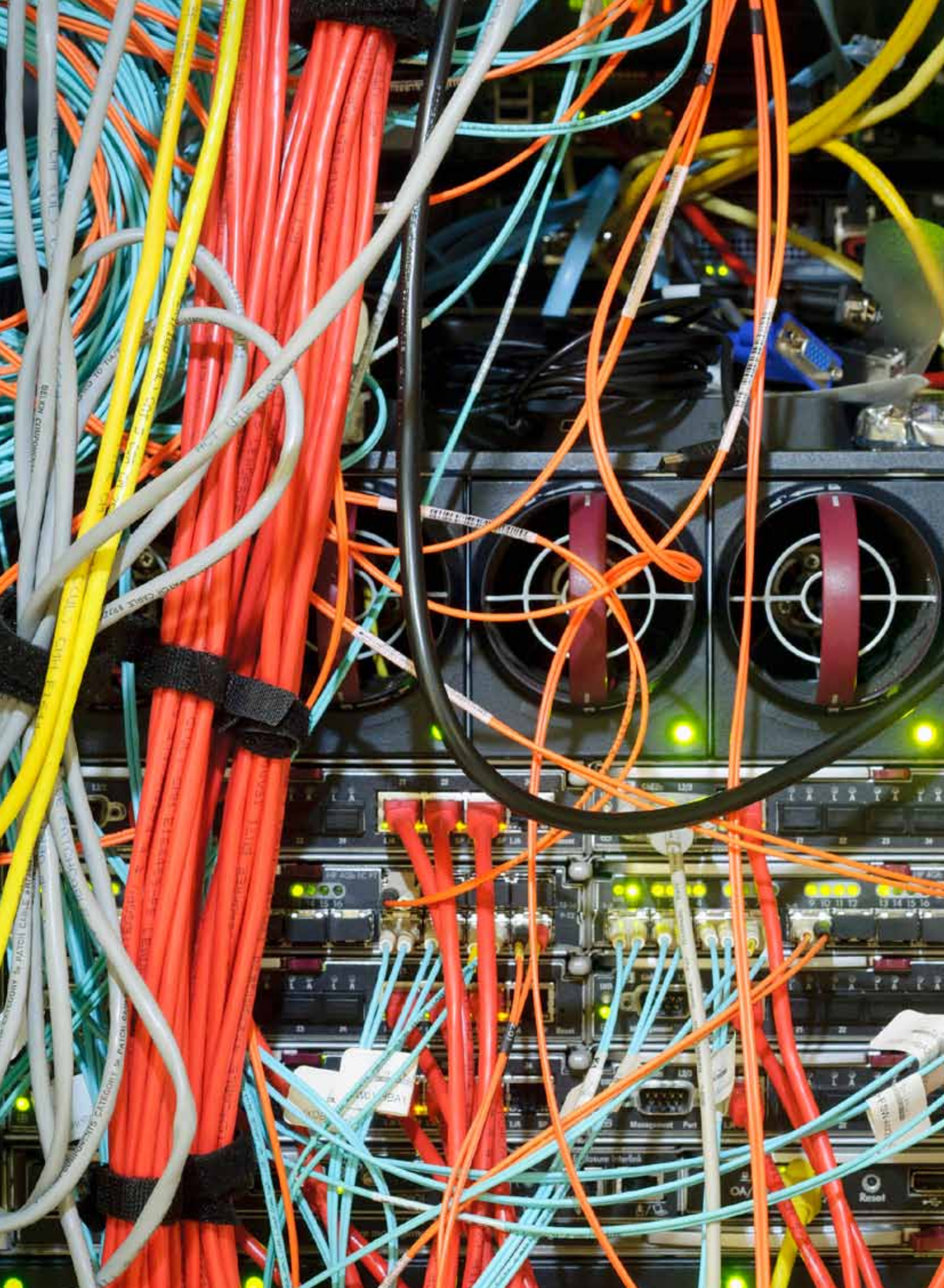
**For customers of banks the impact of these changes is stark – banking products and services have become more expensive, and in some cases the availability of products and services has been constrained.**

**M**any structural changes are already under way, including significant deleveraging by many European banks as they strive to improve their capital and liquidity ratios. Other changes are being assessed by banks, and may follow as the detail of unfinished regulatory requirements becomes clearer, and as the cumulative impact of regulatory reforms becomes fully apparent.

In wholesale markets the end result is already beginning to emerge, with a small number of 'scale' players becoming even more dominant. In retail markets the end game is less clear, but may involve regulatory protection for local players, operating in less competitive markets.









## EU PROPOSALS FOR STRUCTURAL MEASURES



Following the Liikanen report in October 2012, the European Commission proposed in January 2014 a Regulation on structural measures for improving the resilience of EU banks.

The proposed Regulation has two main elements:

→ A ban on proprietary trading, defined as trading for the sole purpose of making profits for a bank's own account, without any link to actual or anticipated client activity or to the hedging of client-related positions. Banks would also be prohibited from owning, holding shares in, or sponsoring alternative investment funds.

This prohibition would not apply to trading in sovereign debt issued by EU member states.

→ A structural separation power for national authorities to prohibit a 'core' credit institution (a bank that takes deposits covered by a Deposit Guarantee Scheme) from undertaking trading activities.

This could be applied if a bank's trading activities pose a threat to the financial stability of the bank or of the financial system as a whole, or to any of the objectives of the Regulation (including excessive risk-taking and resolvability).

Structural separation would have to be applied if a bank's trading activities exceed a set of assessment metrics (including size, complexity and profitability) – unless the bank can demonstrate that its trading activities do not pose a threat to financial stability or to the objectives of the Regulation.

To meet this structural separation provision, a banking group would have to structure itself into at least two sister banks (the core deposit-taking bank and a trading bank), so that the two banks are legally, economically and operationally separate. A core deposit-taker could not undertake trading activities – or own any entities undertaking trading activities – while a trading entity could not take core deposits. Strict intra-group and extra-group large exposure limits would also apply to core deposit-takers.

However, even where the structural separation power is exercised, a core bank could still carry out trading activities to manage prudently its own risks and to provide a restricted range of risk management services to customers.

These two elements would apply to:

- EU headquartered G-SIBs;
- Banks (established in the EU, or with an EU parent, or branches of a third country bank) that over three consecutive years have total assets above €30 billion and trading activities exceed €70 billion or 10 percent of total assets; and
- Smaller banks if the provisions are deemed necessary on financial stability grounds;
- However, branches of third country banks can be excluded if they are subject to equivalent rules from their home regulator.

The Commission estimates this would apply to around 30 EU banks and to some branches of third country banks.

A member state can request a derogation from the Commission from the structural separation requirement (but not from the prohibition on proprietary trading) for a bank if national legislation was in force on 29 January 2014 that already requires at least an equivalent degree of separation. The recent French, German and UK legislation on structural separation may meet this test.

The proposed Regulation envisages a timeline under which a list of covered (and exempted) banks is published annually from 1 July 2016; the prohibition on proprietary trading takes effect from 1 January 2017; and the structural separation provisions from 1 July 2018.

### Implications for banks

These proposals represent a major constraint on how large banks can operate, in addition to all the other national, EU and international regulatory reforms. Banks therefore face a strategic challenge to determine their optimal business model in response to these constraints.

Large EU banks would have to stop proprietary trading throughout their groups, and put in place internal control processes to ensure that trading activities do not 'cross the boundary' between allowable and non-allowable activities. The extremely complex and lengthy regulations introduced in the US to implement the 'Volcker rule' show how difficult this can be in practice.

Similarly, the structural separation of core deposit-taking and trading activities is both complicated and costly. It will involve not only the creation of entities that are legally, economically and operationally separate, but also the continuous internal policing of the boundaries between these entities.

A separate trading entity (investment bank) within a banking group may be subject to a separate external rating and may find it more difficult and expensive to raise funding. It may also find that some counterparties are no longer willing to trade with it. Some banking groups may find that their investment banking activities are non-viable as a result of being sub-scale and too expensive to operate and to fund when they are separated out from a retail bank. This could reinforce the pressures on EU investment banks to pull out of some markets, and place these banks at a competitive disadvantage.

**It is not clear what value structural separation brings in addition to higher capital requirements, recovery and resolution planning, and the more intensive supervision of systemically important banks.**

## Regulation

Regulatory initiatives are driving banks' decisions on structure through three main routes – direct legislative or regulatory requirements for structural separation; the indirect impact of capital and liquidity requirements; and localisation.

### Structural separation

The most direct regulatory pressure on structure is through the rules being introduced on structural separation – most notably for Europe with the Commission proposals published in January 2014 (see box). Some countries – including the UK, France, Germany and Belgium – are developing, or have already introduced, legislative requirements for structural separation between differing types of retail and investment banking activities, while in countries such as the Netherlands and Belgium a succession of failures as a result of the financial crisis has already led to the break-up of universal global banks.

The driving forces behind all these legislative initiatives have been to reduce the size and complexity of previously 'too big to fail' banking groups; to limit the extent to which insured retail deposits can be used to support investment banking activities; and to enable retail banking operations to be more easily carved out and transferred or supported in the event of a large banking group running into difficulty. Cultural change has been added to this list – driven by the revelations on the fixing of LIBOR and foreign exchange benchmarks.

Structural separation requirements are in effect a sub-set of resolution planning, since they place specific critical economic functions in an operational, institutional and governance structure that would make it easier to continue these critical functions within the resolution of a failing banking group. Other critical economic functions may be similarly identified and structured in due course, albeit through less severe forms of ring-fencing.

Regulatory restrictions are also being introduced to improve the resilience of markets rather than of individual banks. These include the trading, clearing and reporting of derivatives transactions; and restrictions on central clearing counterparties and their members.

However, it is not clear what value structural separation brings in addition to higher capital requirements, recovery and resolution planning, and the more intensive supervision of systemically important banks.

Structural separation does not prevent ring-fenced retail banks taking on risk through the asset side of their balance sheets, while on the other side of the fence trading entities can be systemically important and therefore cannot be simply ignored. And creating separate entities within a single banking group cannot entirely eliminate spill over effects.

### Capital, funding and liquidity requirements

Although there are wide differences in view on the cost of imposing tougher capital, funding and liquidity requirements on banks, the overall impact of regulatory reform initiatives in this area has been – and will continue to be – substantial. As discussed in Chapter 1, these initiatives include not only Basel 3 itself, but also the capital surcharges, resolution planning requirements and more intensive supervision of (at least) systemically important banks; requirements to hold bail-inable debt; the likely outcomes on the leverage ratio, risk-weighted assets and the ECB Comprehensive Assessment; and stress testing more generally.

These regulatory reforms are shaping banks' business models and pricing, with new minimum capital, leverage, loss absorbency and liquidity requirements and new asset class risk weightings determining the liability structure and the minimum returns required to meet the cost of capital and other funding. This also reduces the flexibility of banks to determine which clients, products and markets they engage with.

In addition, as discussed in Chapters 3–5, higher regulatory costs are also being imposed through a host of other regulatory requirements, ranging from retail and wholesale market conduct requirements to reporting and risk governance. These costs have to be borne by shareholders, customers and market end-users.





## Host country authorities are becoming increasingly unwilling to rely on the capital, liquidity, funding and regulatory oversight of the parent bank.

### Localisation of finance

Host country authorities are focusing more on preventing the failure of the local operations of foreign banks where they are of systemic importance for the local system, on maintaining critical local economic functions in the event of failure, and on protecting local creditors and taxpayers in the event of the failure of a foreign bank. Host country authorities are therefore increasingly requiring foreign banks to operate within the host country as subsidiaries rather than branches; to meet local standards – on capital, liquidity, stress-testing, bail-in liabilities and governance and risk management (either as subsidiaries or as ‘synthetic branches’); and to limit their intra-group exposures and their reliance on shared services.

Meanwhile, moves to introduce greater structural separation, home country recovery and resolution planning, and a ‘single point of entry’ approach to the use of the bail-in tool has reduced the confidence of some host country authorities that the local operations of foreign banks will receive support from the home country authorities in the event of difficulties arising in an international banking group. Host country authorities are becoming increasingly unwilling to rely on the capital, liquidity, funding and regulatory oversight of the parent bank.

International banking groups face difficulties in accommodating so many national regulators, often with a lack of commonality of objectives and trust between the home and host supervisors. These groups want to be global in terms of products, services and customers, and have generally adopted business, operating and governance and risk models that are consistent with this vision. They are trying to adapt and substantially preserve this vision given its competitive and other advantages,

while accepting that an undiluted global view is no longer viable after the financial crisis.

For international banking groups, the main cost of greater localisation is a declining ability to manage capital, liquidity, funding and bail-in liabilities at a group level. Holding ‘trapped’ resources in each relevant jurisdiction pushes up the cost of doing business, with an impact on the cost of products and services to customers. Similarly, booking transactions in multiple locations reduces the advantages of netting, the efficient use of collateral, and the efficient use of capital.

One ray of hope here is that within the European banking union the ECB should facilitate a greater emphasis on group-wide capital, liquidity, funding, risk management and governance requirements, and push back against the localisation of these requirements.

## What are banks doing?

Regulatory drivers do not operate in a vacuum. Macro-economic developments, market competition and technological advances are also key factors. And banks are keen to control their own destiny, determine their own commercial strategy, or at least to preserve a high degree of optionality as regulatory requirements evolve. But whatever the drivers, some key themes can be identified in how banks are responding to regulatory and other pressures.

### Legal entity re-structuring

Banks subject to national requirements to ring-fence specific activities are already planning to implement the necessary changes. More generally, the proposed EU legislation on structural separation and the emphasis on resolution planning by the authorities are leading banks to consider their operating and legal entity structures. Many banks are taking a cautious approach here, waiting to see how regulatory expectations evolve – not least because in many jurisdictions the authorities are yet to reach any conclusions on how (if at all) banks should restructure in order to make resolution a credible option.

### **/ Banks need to create a viable business model with:**

- a legal entity structure that would enable the resolution authorities to apply their resolution tools and powers effectively to regulated entities within their jurisdictions;
- a financial model that can support the costs of the new liability requirements (capital and additional loss absorbing capacity) where it is needed at different points in the legal entity structure; and
- an operating model that delivers both efficiency and operational continuity of internal and external suppliers in support of critical functions.

Banks also need to consider how to reflect the cost of recovery optionality and resolution flexibility in their pricing.

Some banks are pressing ahead with restructuring, in particular where the necessary changes to their business models in response to the financial crisis and regulatory expectations are clear. There is no single model here, but the general shape of restructuring has focused on moves towards:

- A top level holding company (in part to meet regulatory pressures for a 'single point of entry' approach to bail-in debt);
- Operating subsidiaries that reflect a closer alignment between business activities and legal entities, based on a simplification and rationalisation of legal entities;
- Meeting local regulatory requirements for capital, liquidity, recovery and resolution, governance and risk management capabilities;

- Implementing clearer and better understood governance, control and accountability structures within the key operating entities;
- A more regional 'hub' structure and approach to running businesses and managing risk, including to booking trades and transactions – although it remains unclear whether this will be a stable end-point in either commercial or regulatory terms;
- Either a decentralisation of services to individual entities with the group, or the creation of a 'resolution-proof' shared service provider structured as a separate entity within the group; and
- Simplifying and netting down trades with major counterparties.

### Focus on core activities

Many banks have been re-evaluating where they want to remain active, in terms of markets, geographies and customer segments.

### **/ Banks need to consider which business activities can succeed in the new financial and regulatory environment, and which activities are 'non-core' or 'marginal' as a result.**

In some cases this choice has been exercised by the authorities, as a condition of banks receiving some form of state aid, with banks being forced to sell, transfer or withdraw from various types of business. This has been most evident in Ireland, where the entire retail banking market has been restructured through the transfer of a large proportion of assets to a national debt management agency and a marked reduction in the number of major retail banks.

In other cases this has been a commercial decision, driven by a variety of factors such as profitability and the volatility of profits; the balance between risk and reward; customers and markets; the efficient use of capital, liquidity, funding and leverage; competitive advantages and the comparative advantages of the bank's people, systems and IT infrastructure; complexity; the degree of understanding of the business; and operational risk, regulatory risk and taxation.

Retail and corporate banks have generally pulled back most sharply from international business activities, including sales of overseas business units and a sharp reduction in overseas lending by many banks.

Investment banks have in many cases withdrawn from specific business lines (for example some segments of fixed income and commodities trading) while seeking to maintain a scale presence in whichever business lines they consider to be 'core' activities.

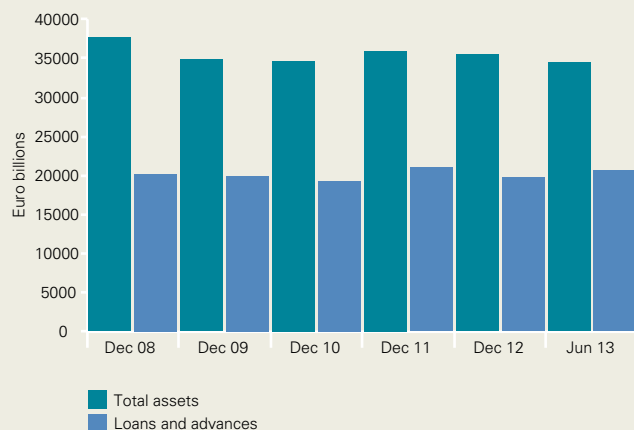
Overall, this has resulted in:

- Many banks becoming less diversified in terms of business activities and more concentrated in a single country or region;
- Some universal (retail and wholesale, or some combination of banking, insurance and asset management) banks considering whether they can remain universal – and indeed their hand may be forced by the proposed European legislation on structural separation;
- A smaller number of large-scale players in each wholesale market;
- Potential for the remaining players in each market to make higher returns;
- A more pronounced bifurcation in the distribution of banks in each market and location, between a (smaller) number of large players and a large number of smaller players – although more mid-size players may emerge from consolidation among the smaller players; and
- Greater scope for the emergence of local and regional players, for example in Asia, India and South America, which may be reinforced by the increasing importance of South-South trade and finance.

**Retail and corporate banks have generally pulled back most sharply from international business activities, including sales of overseas business units and a sharp reduction in overseas lending by many banks.**

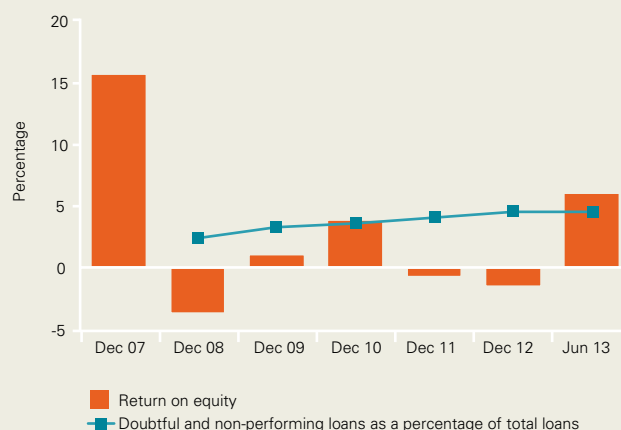
## EUROPEAN BANKS: BALANCE SHEET ADJUSTMENT

### BALANCE SHEETS AND LENDING FLAT



Source: ECB Consolidated banking data (all EU banks)

### PROFITS WEAK OR NEGATIVE



**Many banks in Europe have struggled to strengthen their capital. Most have had to rely more on retained earnings than new capital issues.**

#### Balance sheet size and structure

A combination of regulatory and market pressures is forcing banks to assess their capital and liquidity positions against the 'fully loaded' (not transitional) minimum Basel 3 and CRR requirements. The latest Basel Committee and EBA analyses (using end-2012 data) of how banks are measuring up against these requirements show continued progress towards meeting capital requirements, and the favourable impact of the Basel Committee revisions to the LCR in taking many banks to above a 100 percent LCR.

However, it is also clear that EU banks have been slower to adjust than non-EU banks, leaving a high proportion of the remaining shortfalls concentrated in EU banks. The 42 internationally active EU banks covered by the EBA analysis show:

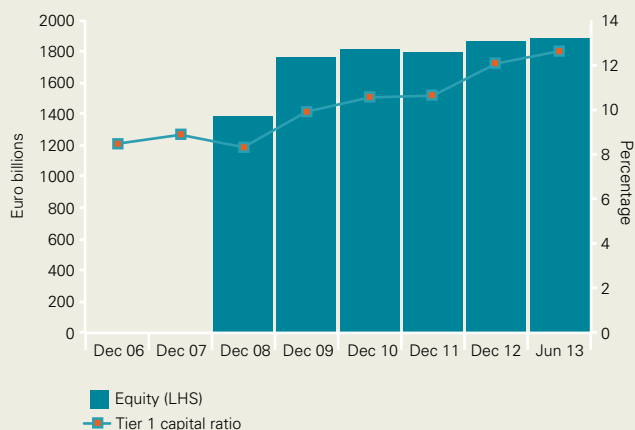
- A shortfall of around €70 billion against a 7 percent CET1 capital ratio (and prospective G-SIB capital surcharges). These shortfalls would be even larger if the 'target' also included D-SIB capital surcharges, 'Pillar 2' capital add-ons, and any macro-prudential measures;
- An average leverage ratio of 2.9 percent (down from 3.0 percent at end-June 2012), with 18 of these banks showing a leverage ratio below 3 percent; and
- An average LCR of 109 percent, but 17 of these banks are below a 100 percent LCR, and 7 of them are below the 60 percent LCR that will apply in 2015.

Against this background, it is not surprising that many European banks have been taking steps to reduce their risk and leverage, and to increase their holdings of high quality liquid assets, in particular government bonds.

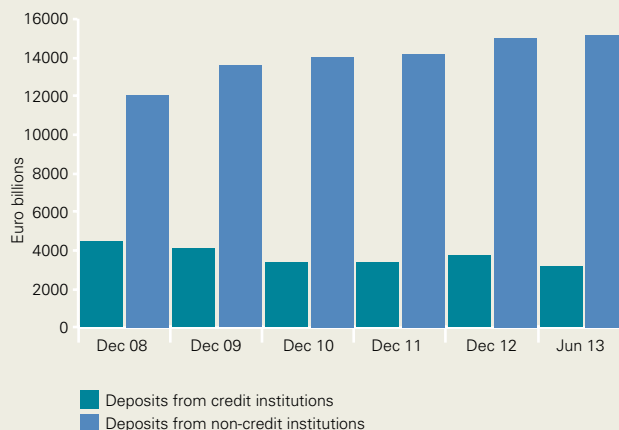
Indeed, there is a growing contrast between this focus of many European banks on capital, leverage, liquidity, funding and regulation more generally, and the focus of an increasing number of US banks on growth, the recovery of net income and profitability. Mortgage growth and margins have been a lone bright spot in Europe.

**Capital** – many banks in Europe have struggled to strengthen their capital. Most have had to rely more on retained earnings than new capital issues, although the flow of retained earnings has been constrained by stagnant net income and low profitability. Low returns on equity, in some cases below the cost of capital, have not provided attractive conditions for new capital issues, although some large banks have managed to raise new capital.

## SLOW BUILD UP OF CAPITAL, BUT SHARPER IMPROVEMENT IN CAPITAL RATIOS



## REDUCED DEPENDENCE ON INTERBANK DEPOSITS, BUILDING UP CUSTOMER DEPOSITS



**Risk-weighted assets** – overall, banks in Europe have reduced significantly their risk-weighted assets, through a combination of (a) no balance sheet growth; (b) shifts in the composition of total assets, away from non-domestic lending and from consumer credit and corporate lending, and into increased holdings of government bonds and modestly higher retail mortgage lending; and (c) sharp reductions in trading book activities at many European banks with substantial trading books. These trends seem set to continue, with some major banks having announced plans for further significant reductions in their on- and off-balance sheet assets. Banks are getting smaller to become less risky, more capital efficient and more profitable on both an accounting and a risk adjusted basis.

Part of the explanation of these balance sheet shifts may lie with the weakness of the economy in most European countries, and hence lower demand for borrowing by corporates and less willingness of banks to lend to customers perceived to be risky. But a significant part is the result of the pressures on banks to meet capital and liquidity ratios.

**Capital and leverage ratios** – the reduction in risk-weighted assets has been the primary contributor to a pronounced improvement in capital ratios across European banks, while modest increases in equity combined with flat balance sheets and reductions on trading books have resulted in some improvement in leverage ratios.

**Funding** – in addition to the modest increase in capital, other shifts on the funding side have included a marked reduction in short-term wholesale funding, a build-up of customer deposits, and debt issuance. However, this overall picture masks differences across countries, with customer deposits falling at banks in Greece, Ireland and Spain; and with marked differences between the ‘core’ and ‘periphery’ euro area countries with respect to the ability of banks to issue longer-term debt. The proposed tighter regulation of money market funds may place additional pressure on banks to find alternative sources of funding, while at some point many banks – especially in Greece, Ireland, Italy, Portugal and Spain – will need to wean themselves off the liquidity support they are still receiving from the ECB.

**The reduction in risk-weighted assets has been the primary contributor to a pronounced improvement in capital ratios across European banks.**

## Cost reduction

**Banks are seeking to reduce their costs, not least in an attempt to offset the cumulative impact of regulatory reforms on the costs of funding, compliance, reporting, risk management and governance. This is becoming more critical in an environment of lower returns, especially in investment banking.**

Many large investment banks have already announced cost reduction plans, or at least strategic reviews, where a key issue will be to reduce their cost: income ratios from the bloated levels they reached in many banks. More benign economic conditions in 2014 may facilitate an improvement in the cost:income ratio, through both higher income levels and opportunities for asset and business unit sales.

Many sources of cost reduction are being explored, including:

- Greater efficiency of processes and data management, through investment in IT systems;
- Closing branches and relying more on centralised and increasingly automated and industrialised front to back office processes;
- Focusing more on the overall profitability of products and services, and on where a bank has a competitive advantage, rather than justifying new or incremental products and services on the basis of their marginal contributions to profit and loss;
- Simplifying products and services, and taking a more risk-adjusted approach to costs and revenues;
- Greater automation of some controls, including compliance and internal audit, based on a re-assessment of risk tolerance in these areas;
- Simplifying legal entity and operating structures;
- Reducing staff numbers;
- Reducing variable remuneration, on the basis of weak economic conditions and regulatory constraints on remuneration; and
- Off-shoring and near-shoring.

## Impact on customers

At a micro level, customers of banks are being faced with a higher price and reduced availability of banking products and services. In retail banking this has fed through in terms of higher margins on lending, while in wholesale markets the shift to fewer providers of each product has resulted in both higher prices and reduced choice for customers. Meanwhile, some customers are being cut off from products and services (irrespective of price) on the basis that the risk to the bank is too great – be it prudential, conduct or wider reputational risk.

These price and supply decisions reflect both the costs of tougher regulation and banks adopting a more risk-based approach to pricing and markets, with capital and funding costs and other risk factors being allocated to individual profit centres and individual business lines.

International corporates want banks that can facilitate trade finance, make payments, provide credit, book trades and provide risk management services on a global basis, in support of global trade and investment. But the trend toward the localisation of finance is making this more difficult and expensive to provide.

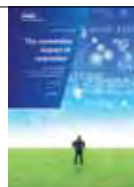
At the macro level, tougher regulatory requirements are reinforcing the downward spiral in Europe of weak or in some cases negative economic growth; increasing government debt and continuing public sector and central bank support for some banks; decreasing lending by banks to corporates in particular; and increasing arrears and non-performing loans.

There is scope to break out of this downward spiral through stronger economic growth, the potential profitability of banks lending into the upturn, private investors being more willing to subscribe new capital for banks and to accept lower return on equity, and enhanced investor perceptions of the soundness of banks in the European banking union once the ECB's Comprehensive Assessment has been completed and acted upon. But none of these positives can be taken for granted.

Moreover, the cumulative impact of regulation in Europe may have gone past the 'tipping point' to a situation where the costs of regulation exceed the benefits. These costs have to be paid, and to a large extent it will inevitably be the customers of, and investors in, banks who pay these costs through higher prices and lower returns. The much greater reliance on bank financing in Europe than in the US accentuates this impact on customers and investors. ■

**The cumulative impact of regulation in Europe may have gone past the 'tipping point' to a situation where the costs of regulation exceed the benefits.**





## THE CUMULATIVE IMPACT OF REGULATION

Detailed analysis by KPMG member firms in the Netherlands and Belgium has provided a bank and customer perspective on the cumulative impact of regulation. This work involved four key stages:

- Qualitative discussions with local banks about which regulations were likely to have the greatest impact on banks' financial position, business model, operating model and change capacity;
- Identifying from this qualitative analysis the four most significant regulations – CRR/Basel 3, Financial Transactions Tax, bail-in debt and the pre-funding of deposit guarantee schemes;
- Quantitative analysis of the impact of these four regulations on banks' capital, leverage and liquidity regulatory ratios, and the impact on net income, profitability and cost:income ratios in the absence of any actions by the banks; and
- Assessing the extent to which banks could mitigate the impact of these regulations by taking management

actions, such as reducing costs, repricing loans, issuing new capital, retaining profits by not paying dividends, changing the structure of assets (holding more high quality liquid assets) and liabilities (raising long-term wholesale funding), and reducing the size of the balance sheet.

Three core findings emerged from this analysis.

- In the absence of any management actions, many banks would fail to meet minimum regulatory requirements and would see their return on equity fall below 8 percent.
- A radical set of management actions would be required to enable the banks both to meet all the minimum regulatory requirements and to achieve an 8 percent return on equity. This could not be achieved by cost reductions alone, but would require a combination of actions.

In the central scenario this would require:

- A 9 percent reduction in the size of the balance sheet;
- An increase in the price of loans by 80–90 basis points;
- No payment of dividends;
- A 5 percent reduction in costs; and
- Replacing the equivalent of 2.5 percent of total liabilities with long-term wholesale funding.

- Such a set of management actions would have significant implications for customers of the banks and for the financing of the wider economy, in particular though less and more expensive credit and the provision of fewer risk management products and services.

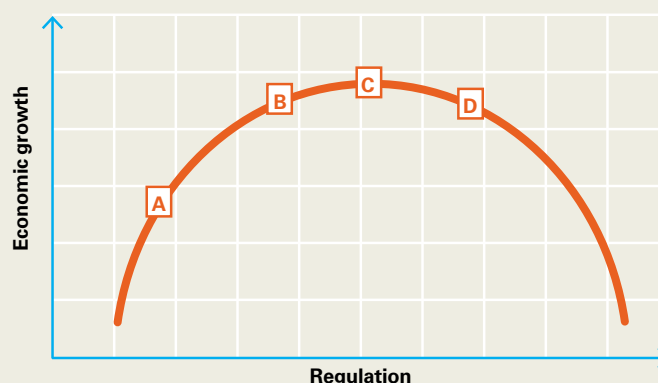
## Impact of regulation on the wider economy

As KPMG has argued elsewhere, the relentless introduction of more and more regulation may already have taken many economies, especially in Europe, beyond the 'tipping point' to a position where the costs of regulation exceed the benefits – in terms of the permanent downward drag on economic growth exceeding the benefit of avoiding future periods of financial instability.

The relationship between regulation and economic growth may be illustrated by a simple chart, plotting these two variables. Up to a point, regulation promotes economic growth, because the negative impact of regulation on economic growth in normal times is more than offset by avoiding the severe costs of financial crises. But there is an inflexion point beyond which the negative impact of regulation on economic growth in normal times begins to exceed the benefits of regulation.

The really difficult question is establishing where the 'tipping point' lies. There is general agreement that before the financial crisis we were at point A, where too little regulation contributed to the costs of financial crises on economic growth. Official estimates of the Basel 3 capital and liquidity reforms moved regulation up to point B, leaving scope for additional regulatory reforms before reaching the 'optimal' point C. However, the evidence in Europe in particular suggests that we have moved beyond point C to point D, where excessive regulation is so damaging to the wider economy that the net impact of regulation on economic growth has become negative.

Regulation versus economic growth



*'Integrity has no need of rules.'*

Albert Camus

# 03 Conduct, Markets and Culture

**A series of conduct failings in both retail and wholesale markets have emerged in the last few years. This will intensify the introduction of international and national regulatory initiatives in the conduct area, over and above the progress made on the 'MiFID 2' package and related EU and national initiatives.**

**For customers the end result in both retail and wholesale markets is likely to be very similar to the impact of prudential requirements – more expensive products and more restricted choice.**

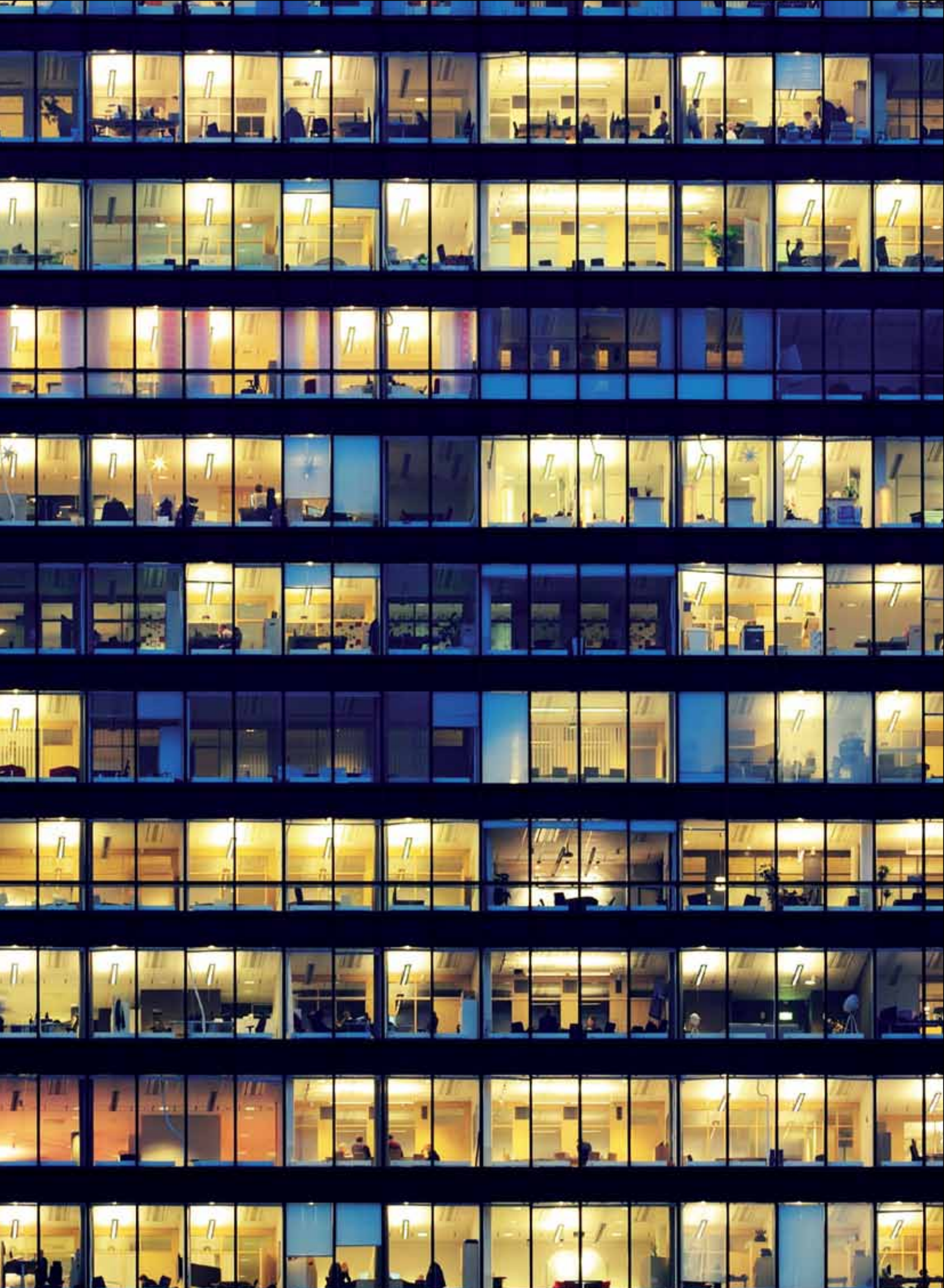
**T**he 'product push' approach to banking – focused on the desire to sell, rather than a more thoughtful view of what would best suit the needs of the customer – has led in retail banking to the various mis-selling disasters of recent years and in wholesale markets to significant and widespread market conduct issues.

Most banks are looking to become more customer centric, and have begun to make some progress in addressing cultural and behavioural issues – but this journey is far from complete. Significant change in the culture and values of many banks is required to meet the needs of customers and regulators.

At a more detailed level, while most wholesale banks have embarked on projects to meet the new requirements of EMIR and MiFID 2, some retail banks are waiting for the detailed implementation of MiFID 2 at the national level before instigating major changes. However, other retail banks are already focusing on the prospective shift in Europe to a more 'product life-cycle' approach to regulation, and considering the implications of this for product design and development, customer treatment and channels of distribution.









## RETAIL MIS-SELLING PROBLEMS FROM ACROSS EUROPE

A survey undertaken by the Joint Committee of the European Supervisory Authorities, and published in November 2013, reported actual or potential problems arising from the selling of complex products with potentially volatile outcomes to retail consumers:

TYPE OF PRODUCT	COUNTRY
Highly (and increasingly) complex products, such as structured products	Belgium, Denmark, Estonia, Germany, Italy, Latvia, Spain
Complex hedging products designed to protect borrowers on flexible rate mortgages	Latvia, Spain
Self-certified and interest only mortgages	UK
Mortgage insurance products	Poland
Loans to individuals that are exposed to exchange rate risks, the extent of which is often unknown to the consumer	France, Hungary
Unregulated collective investment schemes, which invest in assets that are not always traded in established markets, are therefore difficult to value, may be highly illiquid, and have risks to capital that are generally opaque	UK, Germany
Units in funds based on hedging strategies	Belgium
Product wrapping which prevents consumers from comparing features, prices and charges and thus from making well-informed investment decisions	Finland
Banks placing financial instruments such as hybrid products with their own retail clients, where the risks were in some cases not disclosed or sufficiently explained and some consumers claim that they were given the impression that the investment was a protected deposit	Spain, UK
Insurance products linked to complex underlying structures	France
Expensive and opaque unit-linked insurance and pension products	Netherlands
Structured insurance products with investment elements that are often sold cross border but contain only 1 percent of mortality risk	Norway

### Conduct failings

In addition to earlier large-scale mis-selling episodes that have now moved into a remediation stage (such as the mis-selling of Payment Protection Insurance (PPI) in the UK, where remediation costs exceed £12 billion), other cases of actual or suspected mis-selling to retail customers have emerged across a wide range of countries (see box).

Meanwhile, in wholesale markets a number of major international banking groups have been fined for their involvement in the rigging of LIBOR (and other interest rate benchmarks), and for colluding in doing so, and criminal proceedings have begun against some individual traders. Regulators and other authorities are also investigating a possible conspiracy to shift foreign exchange market prices, and possible market misconduct in swap, commodities and energy markets.

In addition, some banks may have mis-sold interest rate swaps to SMEs and municipalities (in the UK, Germany and Italy), while a number of banks have been found to be seriously deficient in their anti-money laundering and client money procedures and controls.

These failings have multiple causes, including cultural failings, a push for revenue at the expense of customers and counterparties, ineffective governance and controls, poorly designed processes, inadequate training and an under-investment in enabling technology. There is no single answer to these failings.

These failings have resulted in large costs for many banks, including from fines, the high costs of remediation, the cost of staff, systems and other resources to address the problems, the drain on management time and attention, and reputational damage. Close scrutiny from supervisors and other authorities may lead to the discovery of additional problems, and further costs to some banks.

Indeed, in many respects these failings may prove to be as important to banks and their regulation as the initial financial crisis. They have been a reputational catastrophe for both the banks involved and the wider banking sector.

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## MIFID 2: RETAIL CONSUMER PROTECTION

### Retail – Product and sales lifecycle



**Note:** The coloured boxes refer to existing or amended requirements from MiFID 1, while the white boxes are new requirements under MiFID 2.

### Regulation: the retail conduct agenda

#### Global

The G20 prioritised consumer protection as one element of its post-crisis regulatory reforms. The Organisation for Economic Co-operation and Development (OECD) developed a set of high level consumer protection principles, which it published in October 2011, and in September 2013 the OECD published a more detailed analysis of the approaches taken by national authorities under three of these principles – disclosure and transparency; responsible business conduct; and complaints handling and redress. This has provided national authorities with a useful check list against which to consider possible gaps in their approaches to consumer protection, and to consider how they might bring their consumer protection framework into line with international good practice.

#### Europe

Meanwhile, progress has been made in the EU on consumer protection legislation. Most importantly, the 'MiFID 2' package of a Regulation (MiFIR) covering mostly market infrastructure and a Directive (MiFID 2) was agreed in January 2014. The main aspects of retail consumer protection covered by the Directive are:

- **Strategy** – the importance of a clear focus on consumers;
- **Product governance** – the need for product manufacturers to design, target and document products in a way that reflects investor needs;
- **Advice** – transparency in the distinction between independent and non-independent advice; giving advice on the appropriateness and suitability of products; and the banning of commission on investment products being paid to independent advisers or to discretionary portfolio managers;
- **Best execution** – on non-advised sales;
- **Post sales service** – including complaints handling;
- **Banning products** – ESMA (and the EBA for structured deposits) and national authorities have the power to prohibit or restrict the marketing and distribution of financial instruments; and
- **Third country regime** – member states can prohibit the cross-border marketing of services by an investment services provider, even if the provider is approved in another member state.

**There is a need for product manufacturers to design, target and document products in a way that reflects investor needs.**

**There is a growing recognition that transparency and disclosure to retail customers is not sufficient, because retail consumers remain in a weak position in terms of their lack of understanding of many financial products.**



The European Securities Market Authority (ESMA) has already begun to develop technical standards for implementing the MiFID 2 package.

Meanwhile, the European Commission published a proposed Regulation in July 2012 on key information documents for investment products – usually referred to as ‘PRIIPS’ (packaged retail investment products). The initial proposal focused narrowly on disclosure and transparency, but the European Parliament in particular has been seeking to extend this proposed Regulation so that it covers a wider range of products and addresses issues such as product complexity, the level of costs and charges, and the powers of national authorities to intervene in retail financial markets.

More generally, there is a growing recognition that transparency and disclosure to retail customers is not sufficient, because retail consumers remain in a weak position in terms of their lack of understanding of many financial products, the imbalance of market power in favour of financial institutions, and the problems caused by various conflicts of interest in retail financial markets.

Below the legislative level, the European Supervisory Authorities (ESAs) are beginning to enter the consumer protection agenda in a more purposeful way, both individually and collectively. The Joint Committee of the ESAs has developed a set of high-level, cross-sector principles on financial institutions’ internal product approval process (see box).

### JOINT COMMITTEE PRINCIPLES ON MANUFACTURERS’ PRODUCT OVERSIGHT AND GOVERNANCE

Partly in response to the mis-selling concerns listed in the box on page 30, the Joint Committee of the European Supervisory Authorities published (in November 2013) eight principles on the responsibilities of manufacturers in designing, bringing to market, distributing, operating and reviewing products.

One key objective of these Principles was to strengthen controls in product manufacturers before products are launched, and thereby to prevent products and services that may cause consumer detriment from reaching the market or from being sold to consumers for whom the products would be unsuitable.

This pre-emptive approach, focusing on the product life cycle, would represent a significant shift in many countries, and would be much more intrusive for banks acting as product manufacturers or product distributors.

The Principles state that a product manufacturer should:

- Establish, implement, and review on an ongoing basis product oversight and governance processes, in particular to ensure that the interests and objectives of target markets are duly taken into account, and to address conflicts of interest;
- Endorse at executive board level the product oversight and governance processes;
- Identify the target market of the product; analyse its characteristics; and ensure that the product meets the identified objectives and interests of that target market;
- Undertake product testing to assess how the product would function in different scenarios, including stressed scenarios, to ensure that the product is aligned with the interests and objectives of the target market, and leads to fair outcomes;
- Ensure that the charges and features of the product are transparent for the target market;
- Select distribution channels that are appropriate for the target market and disclose clear, accurate and up-to-date information to distributors;
- Monitor periodically the functioning and operation of the product to ensure that it continues to meet the objectives and interests of the target market; and
- Take appropriate action when issues that may lead to consumer detriment have materialised or can be reasonably anticipated.



## National

A combination of the MiFID 2 approach to investor protection and the Joint Committee principles is clearly mandating and encouraging national authorities to take a 'product life cycle' approach to consumer protection. This moves away from the more traditional focus on point of sale, and places the regulatory and supervisory viewpoint on product design, the match between product features and customer needs, and whether products are designed to be suitable – and remain suitable – for the intended consumer market. This may narrow the current spectrum of approaches at the national level.

The UK stands at one end of this spectrum, with its long-standing emphasis on the importance of the product life cycle (dating back to the six consumer outcomes specified under the FSA's Treating Customers Fairly initiative nearly ten years ago); the implementation of the Retail Distribution Review from the beginning of 2013; the more recent emphasis of the new Financial Conduct Authority (FCA) on 'conduct risk' and on early intervention to prevent mis-selling; and its proposed new client money rules.

In the middle of this spectrum, some countries have issued detailed conduct requirements in relation to specific types of product, such as the rules in Italy on the selling of illiquid financial instruments, while the Netherlands has banned commission payments on MiFID products.

Austria and Germany stand towards the other end of the spectrum. There is still no concept in Germany of 'conduct risk' as an established risk management category, while the regulator, BAFIN, is rules-based, prefers not to base regulation on high level principles, and is waiting for the MiFID 2 package to be finalised before implementing it at national level. There have, however, already been moves, for example in Germany, to promote fee-based independent advice.

In Germany and other countries at a similar stage of development of the retail conduct agenda, the MiFID 2 package is therefore likely to bring about a significant change through substantially increased scrutiny of long-standing sales practices and incentives systems, and through the introduction of new rules on product governance.

There has already been movement in some countries towards a more intrusive retail conduct regulatory and supervisory regime. The Bank of Spain has increased its focus on the retail conduct agenda, at the same time as some of its prudential supervisory responsibilities for banks move to the ECB; the Central Bank of Ireland has announced that retail conduct will be one of its top three priorities for 2014; and many countries (for example Finland and Ireland) are placing greater emphasis on anti-money laundering requirements.

## Financial Transaction Tax

The February 2013 proposal from the European Commission for a Financial Transaction Tax (FTT) to be adopted by 11 Member States envisaged a start date of January 2014. However, it remains uncertain whether a FTT will be introduced and, if so, when and in what form. Discussions continue on the possible scope of the FTT in terms of types of financial instrument and geography, with a narrower application equating to a smaller projected revenue; while MiFID 2 and the proposed 'Liikanen' structural measures may provide better focused constraints on banks' trading activities.

If it is introduced, the most significant impact on banks is likely to be on systems, products and processes. Business models may have to be amended, or in some cases abandoned altogether. Some banks are actively considering their options, while others are waiting for the details to be decided. Either way, the uncertainty is unhelpful.

## Regulation: the wholesale conduct and market infrastructure agenda

### EMIR and the MiFID 2 package

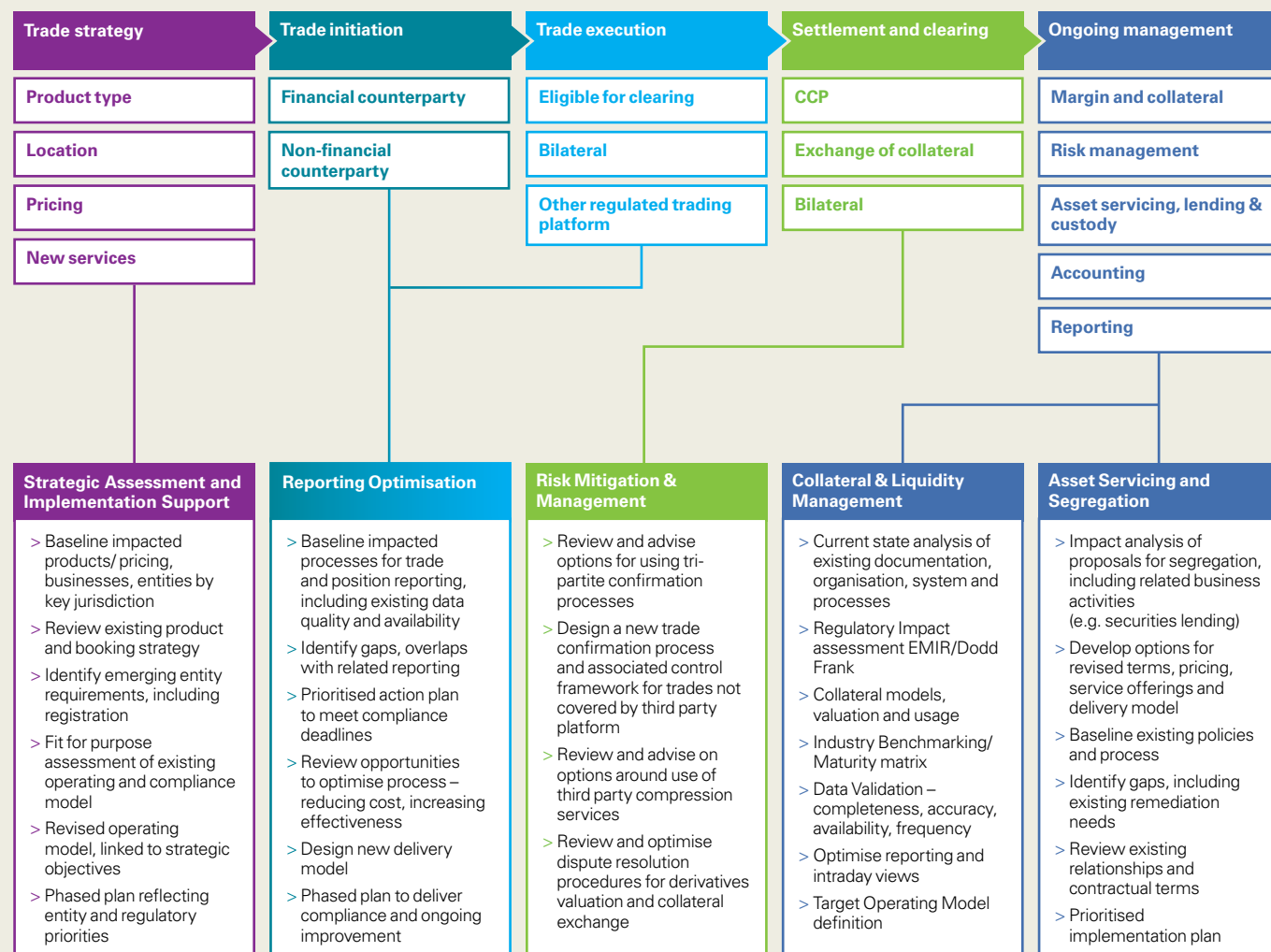
The structure of the wholesale market in the EU is also undergoing significant changes. The European Markets Infrastructure Regulation (EMIR) is essentially directed at reducing systemic risk through the centralised clearing of derivatives. It also covers trade reporting, trade repositories and the performance and activities of central counterparties (CCPs). EMIR entered into force in August 2012, and many of the detailed regulatory and implementing technical standards developed by ESMA were finalised during 2013. Full implementation will stretch through 2014 and possibly beyond, and some of the details remain to be determined.

However, a continuing failure to achieve international consistency between the US and EU regimes for central clearing and trade reporting continues to add cost and uncertainty for both banks and their customers in implementing the necessary changes. Shared regulatory objectives have not prevented differences in the scope of instruments covered by the US and EU legislation; which non-financial counterparties are covered by some of the requirements (the EU regime includes a threshold test); trade reporting, including the products covered, the data that must be provided and the timing and substance of disclosure; clearing venues; and the regulation of CCPs.

Attention therefore remains focused on the July 2013 'Path Forward' efforts by the European Commission and the US Commodity Futures Trading Commission to achieve greater convergence of approach across the US and the EU, although this has made relatively little concrete progress to date. The most likely outcome here is that the practical impact of the international differences will be minimised to some extent as third countries achieve 'equivalence' with the EU regime or are allowed to adopt 'substituted compliance' in place of the US regime.

**A combination of the MiFID 2 approach to investor protection and the Joint Committee principles is clearly mandating and encouraging national authorities to take a 'product life cycle' approach to consumer protection.**

## A STRUCTURED APPROACH TO IMPLEMENTING EMIR



Meanwhile, MiFID 2 and MiFIR:

- Extend the scope of MiFID 1 to non-equity instruments such as bonds and derivatives;
- Add new rules around trade initiation and execution, adding new trading venues and strengthening requirements on how venues are organised;
- Introduce an obligation to trade those derivatives that are eligible for central clearing on regulated platforms;
- Expand the scope of transparency requirements for trade pricing and pre- and post-trade reporting;
- Address areas of market turbulence in recent years such as high frequency trading and commodities trading with new position limits and controls;
- Add powers to ban or restrict inappropriate market practices; and

- Provide for non-discriminatory access to trading venues and CCPs, and for third country access.

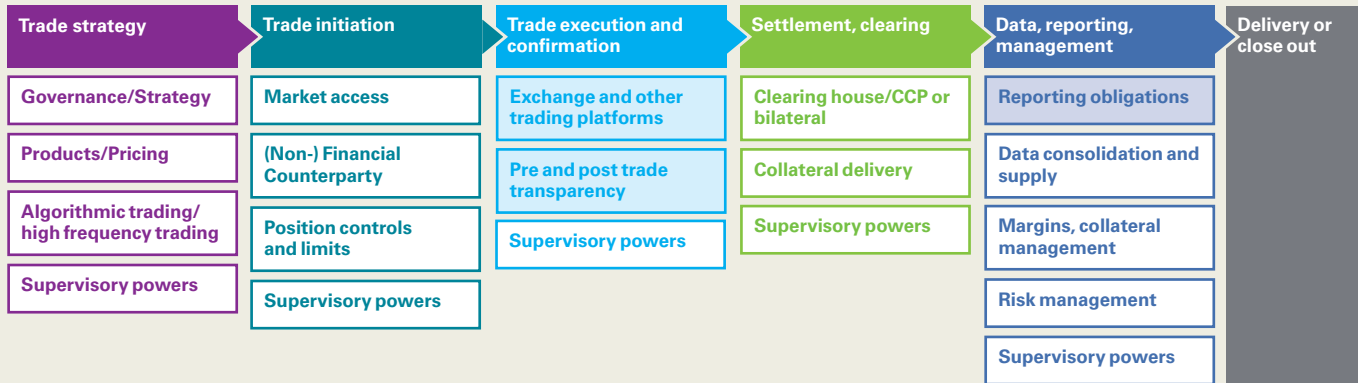
As with EMIR, it will take at least two years to develop and finalise all the detailed technical standards, so full implementation will not be until 2016.

Taken together, EMIR and the MiFID 2 package are already driving significant changes in market dynamics as the increased transparency and corresponding increases in capital and margin raise costs for market participants.

**Taken together, EMIR and the MiFID 2 package are already driving significant changes in market dynamics as the increased transparency and corresponding increases in capital and margin raise costs for market participants.**

## MIFID 2: WHOLESALE MARKET MEASURES

### Wholesale –Trade lifecycle



**Note:** The white boxes are new under the MiFID 2 package, while the coloured ones are amended from MiFID 1.

### What are banks doing?

In retail markets, many banks are not viewing MiFID 2 and related EU legislative proposals as a high priority – both absolutely and relative to everything else that is going on. Many banks are yet to even fully scope how MiFID 2 will affect them, despite the almost agreed final rules. These banks are waiting for the details to be finalised and implemented nationally.

In addition, the focus in some countries on the remediation of previous mis-selling and the backward-looking focus of (some) supervision is crowding out more strategic, forward-looking thinking. Some banks view this as a process of working through every past product and service.

**/** Some banks are beginning to take a more strategic and forward-looking approach, as part of a review of 'conduct risk' and/or a shift to a more customer-centric approach. Such banks are focusing on the product life-cycle, including product design and product governance; product complexity and charges; inducements; distribution channels; conflicts of interest; and taking a more outcomes-driven view of customer satisfaction.

This should result in a less product-driven and more customer-centric approach. Laying the foundations of trust will depend on providing more transparency, simplified products and better quality advice, regardless of the sales channel.

Some universal banks are questioning the combination of the provision and the distribution of retail financial products in the same group. For example, some UK banks have pulled back from offering advice to customers because the regulatory risks are too high to justify the costs of this service, except for high net worth customers. This is also consistent with retail banks shifting to a more automated and less branch-based approach – although automation does not necessarily reduce conduct risk.

**/** In wholesale markets, although some banks have been slow to react to EMIR and the MiFID 2 package, other banks have already responded to actual and prospective changes to wholesale market structures by re-shaping their wholesale market businesses, and focusing more carefully on which instruments, clients and markets they interact with. They are also looking for ways to industrialise revised operations under these new rules to drive out costs and retain margins.

This is already favouring larger players who have the scale to justify significant investment in technology and process and bear the costs of acting as 'clearing members' – the gatekeepers to central counterparties. Central counterparties themselves are also having to invest heavily, under scrutiny from both these clearing members – who set their own capital at risk through membership – and regulators.

In both retail and wholesale markets banks are ending up with high cost operating models, and large increases in risk and compliance staff, and this is being reflected in the pricing of products and services.

In addition, the regulatory pressures on anti-money laundering, tax and client assets are all pushing up the costs of various forms of client 'on-boarding', the refreshing of client details, and the continuing monitoring of clients and the transactions undertaken with them. Some banks are pulling back from some customers and customer types as a result of the risks and costs involved. This is also making it more difficult for small banks to survive, because some of these costs have a disproportionate impact on smaller banks, which cannot then pass on these additional costs to their customers in a highly competitive market.

Banks are also looking for ways to reduce both costs and conduct risk through the automation of trading and processing. For example, the automation of foreign exchange trading and of the reporting of prices and transactions could reduce conduct risk.





**Calls for culture change are commonplace. Successful implementation is much rarer.**

### Culture

It is widely argued that fundamental culture change is needed in many banks if the lessons of the crisis are really to be learned and if a more stable, publicly-acceptable banking industry is to emerge. Banks are therefore under considerable pressure to reform their cultures and behaviours, and to regain trust with regulators, customers and the public.

This is driven by a combination of:

- Regulatory and supervisory considerations, reflecting the perceived failings in culture that led (or failed to prevent) some banks to take excessive credit and market risks and to do so on the basis of inadequate capital, funding and liquidity; to mistreat their retail and wholesale customers; to fail to manage conflicts of interest appropriately; and to engage in inappropriate market conduct;
- Shareholders, customers and other market participants, all of whom see negative consequences from investing in, or transacting with, banks with poor standards of culture and behaviour;
- Other influential players such as politicians and the media, for whom banks have made themselves too easy a target; and
- Banks' self-interest in improving their culture and behaviours and learning some of the lessons from the financial crisis – the only way in which banks can roll back the remorseless tide of new regulation is to demonstrate that they have changed sufficiently to make at least some of this regulation unnecessary.

Calls for culture change are commonplace. Successful implementation is much rarer. It is clear that historical practices were wrong, and need to be changed. A fundamental change in culture and behaviour is an essential step on the road to rehabilitation and the creation of a sustainable and safer banking sector for the future. Some banks are beginning to undertake significant reorientation of their business models and their treatment of customers. Hand in hand with cultural change comes the need for banks to understand, monitor and manage talent risk more effectively. For a sector that is so familiar with risk management as a discipline, the extension of the existing risk framework and practices to incorporate people and talent is a powerful way to underpin lasting cultural change.

**Banks need to show that the root causes of the behaviour that caused the crisis are being addressed, by demonstrating that they are re-balancing stakeholder interests when making core business decisions. Previously, banks demonstrated a disproportionate focus on profit and employee remuneration at the expense of benefits to the customer or market practice. In future, successful, sustainable business models will be built on the fair balance of stakeholder interests.**

Many global banks have started top to bottom cultural change programs. This approach often includes:

- A new 'tone from the top' – clear and public commitments from the chairman and CEO that the old ways of working are not acceptable, and that the journey towards a 'new bank' will include major culture change;
- New, high profile value statements and codes of conduct usually including a principle of ethical, responsible banking and the importance of fair and high quality service for customers;
- A redefinition of the skills and behaviour needed to deliver the business strategy, in an environment focused on risk management, transparency and ethical behaviour;
- Reformed mechanisms (including reward structures) to stop unwanted behaviour being reinforced through misaligned reward and promotion processes; and
- Changes to risk culture, through a strengthening of the role of the Chief Risk Officer and of the risk management and compliance functions.

However, this may not be sufficient to drive fundamental change in culture and behaviour throughout banking organisations. This will require, at least:

- A true commitment from senior executives to transformational change, including a review of the core beliefs and routines that exist within the bank. To be effective it is vital to have visible and authentic role-modelling of values, with leadership demonstrating decisive action to prevent the re-emergence of unacceptable behaviour;
- Some high impact, symbolic actions that demonstrate that the bank is taking culture change seriously, and that there is no going back. These actions could include pulling out of certain business activities, and stopping the sale of, or redesigning, products that are perceived to be contentious or unfair;
- A radical overhaul of traditional norms and routines. This should include variable remuneration incentives – removing them in some cases, and at least adopting a meaningful balanced scorecard approach, with a genuine input from the risk and compliance functions;
- A structured approach to managing people risk, and the incorporation of talent risk into wider risk management governance and reporting; and
- The articulation of clear measures and performance indicators for judging success in changing culture and behaviours, and the communication of these measures and indicators both internally and externally.

**Hand in hand with cultural change comes the need for banks to understand, monitor and manage talent risk more effectively.**

### Impact on customers

Customers should benefit from banks becoming more customer-centric, improving their customer treatment, and enhancing their culture and behaviours. Some customers may also welcome a shift to simpler products sold through more transparent and fairer distribution channels.

However, these improvements also involve costs. In part these arise from higher compliance costs and the frictions added by regulatory requirements to operating models and business models. This will lead to higher prices, fewer providers and distributors, and in some areas to a reduced range of products and to simpler products. Banks are refusing to deal with some customers because the economic costs and regulatory risks of doing so are too high.

In the retail market this raises the possibility of a different 'tipping point', in which regulation has an adverse impact on the amounts of saving, investment and protection that consumers undertake. One particular problem here is that many of these products have to be sold to consumers rather than being willingly bought – so one impact of tougher regulation is simply to reduce the extent to which banks actively sell these products, resulting in what has been described as the 'stability of the graveyard'.

In both retail and wholesale markets, the squaring of the circle on costs, regulation and revenues will inevitably mean that most customers will end up paying more for banking products and services; and some customers will find their choices constrained as banks pull back from markets, geographies and even the types of customer they are prepared to deal with.

Meanwhile, there will be a direct impact of EMIR on non-financial end-users, who will have to assess which requirements apply to them and which legal regime a derivatives trade would fall under; to monitor their operations to ensure that they are maintaining compliance, in particular whether or not they are exempt from requirements; and where applicable to report derivatives trades, or to monitor the processes under which third parties do this on their behalf, and to undertake internal risk management. Banks may become less willing to offer bespoke transactions, and to do so only at higher prices. ■

**In both retail and wholesale markets, the squaring of the circle on costs, regulation and revenues will inevitably mean that most customers will end up paying more for banking products and services; and some customers will find their choices constrained as banks pull back from markets, geographies and even the types of customer they are prepared to deal with.**

*'The price of light is less than  
the cost of darkness.'*

Arthur C Nielsen

# 04 Data and Reporting

**Banks face three major challenges around data management: to hold and use the right data to serve their customers; to meet the wide-ranging and exponential increases in demands from regulators and others for reporting and disclosures; and to respond to supervisory concerns that banks do not have the right data, systems and IT architecture to enable them to manage their risks effectively.**

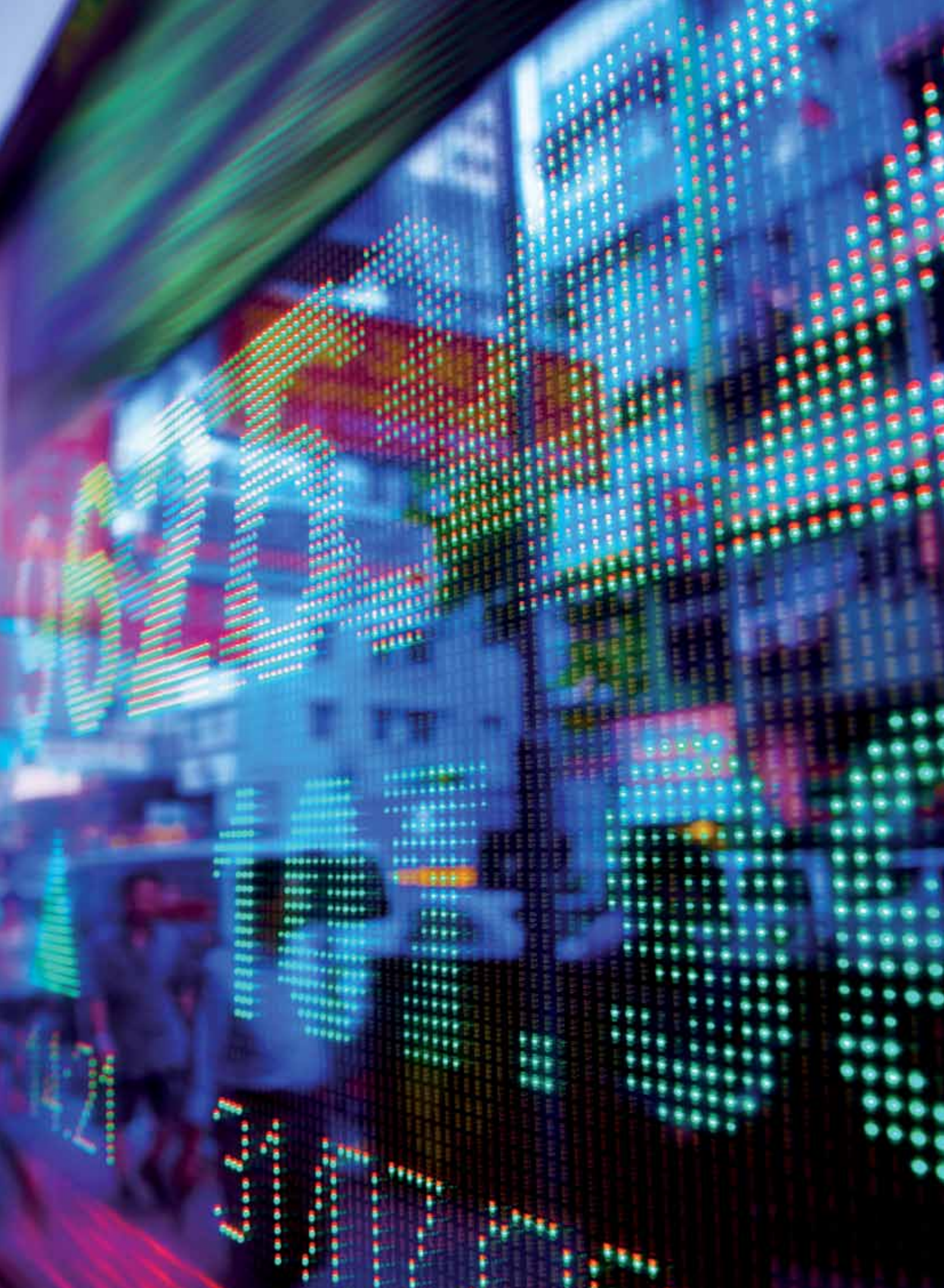
**B**anks face three main pressures for change in their data and reporting:

- The exponential increase in external reporting requirements;
- Regulatory pressure to improve their internal aggregation and reporting of risk data; and
- Business pressures to make better use of their data and to improve the efficiency of their data handling.

This is creating massive costs for banks, and tough decisions over the prioritisation of competing IT projects. Some banks run the risk of building a castle on the sand here, given the absence of existing robust systems.

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.







## DATA AND REPORTING

### Regulation and supervision

One clear consequence of the financial crisis has been an exponential increase in the amount and granularity of data that banks are being required to report to their regulators (see box) and/or to disclose directly to investors and other market participants. Every new regulation brings with it additional reporting requirements, as does the increase in supervisory intensity and coverage, and the growing emphasis on stress and scenario testing. This places considerable costs on banks in terms of the people, systems and quality assurance processes necessary to support this reporting.

This myriad of reporting and disclosure requirements also has an immediate impact on banks' procedures for data capture, data reconciliation (across systems, and between regulatory reporting and financial statements), control processes, and review and governance procedures.

This is being reinforced by the growing emphasis of supervisors on the quality and accuracy of reported data and other information, which in turn has led to an increased focus on individual responsibility for reported data, on banks' internal assurance processes (including the role of internal audit), and on governance (how a bank's non-executive directors

**The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly, accurately, and across all risk types, activities and geographies.**

## INCREASE IN REGULATORY REPORTING REQUIREMENTS

Banks face an exponential increase in regulatory reporting requirements.

### MIFID 2

In the retail area, the changing investor protection framework will impose information requirements on how clients are classified, how the suitability of products is assessed, and how intermediaries are remunerated for recommending particular products.

### RECOVERY AND RESOLUTION PLANNING

Banks are having to provide very detailed information on recovery plans, and to assist resolution planning by the authorities.

### MARKET DISCLOSURES

Enhanced 'Pillar 3' disclosures by banks, including standard templates and greater transparency on internal model-based approaches.

### ANTI-MONEY LAUNDERING AND TAX

Although the details differ, there are growing data and reporting demands on customer due diligence, customer classification, and the reporting of specific information to various authorities.

### INDIVIDUAL NATIONAL SUPERVISORS

Multiplicity of detailed national reporting requirements introduced since the financial crisis.

### COREP

The EBA has developed extensive and detailed common reporting templates covering own funds, asset encumbrance, large exposures, the leverage ratio and the two new liquidity ratios. Take effect from 1 January 2014.

### FINREP

The EBA has developed detailed templates for the reporting of financial information to supervisors, covering assets, liabilities, off-balance sheet exposures, equity, income and expenses. Take effect from 1 July 2014.

### MACRO-PRUDENTIAL OVERSIGHT

National, regional and international macro-prudential authorities are increasing rapidly their collection of system-wide data, including on inter-connectedness within the banking system, and the role of banks in securities financing transactions and in funding the shadow banking sector.

### STRESS TESTING

Regular reporting is increasingly being supplemented by one-off requests to banks to supply data for stress-testing and other purposes. The ECB's Comprehensive Assessment will be a large-scale example of this.

### EMIR AND MIFID 2

Banks operating in wholesale markets face multiple data and reporting and disclosure requirements in areas such as pre- and post-trade information, best execution, reporting of transactions to trade repositories, and various reporting and data requirements on daily mark-to-market positions, collateral, and counterparties.

### OTHER CRR/ CRD4 REPORTING REQUIREMENTS

Ranging from corporate governance arrangements to the country-by-country reporting of profits and taxation.

## INCREASE IN REGULATORY REPORTING REQUIREMENTS

gain assurance about the quality of reported data).

There are also wider issues for banks here, relating not just to data capture but also to how the full range of reporting requirements are identified, and to how data are used to 'police the boundaries' in terms of meeting regulatory requirements, including how activities and transactions are categorised in order to ensure that they are undertaken in the appropriate legal entities.

Banks will need extensible and scalable data to meet all these requirements, perhaps ultimately in the form of a single 'data tape' that can be captured and interrogated by supervisors and other authorities.

Supervisors have also become increasingly frustrated by the inability of major banks to aggregate their risk exposures quickly and accurately at group level, both for internal reporting purposes and for meeting information requests from supervisors. These supervisory concerns are not limited to the state of banks' IT architecture and data gathering – they also extend more generally to the internal reporting of risk data and the use of these reports as an input to properly-informed risk and business decisions.

The key questions for supervisors therefore relate to the ability of banks to aggregate risk data quickly, accurately, and across all risk types, activities and geographies; and to the ability of banks to produce and use high quality management information both routinely and in response to emerging risks as an input to high quality decision making.

The Basel Committee issued a set of Principles on risk data aggregation and reporting in January 2013, and challenged G-SIBs to self-assess themselves against these principles during 2013 (see box). G-SIBs are expected to meet these Principles by 2016, while D-SIBs should do so within three years of being designated as a D-SIB (it is left to national supervisors to undertake this designation). Supervisors may apply the Principles to other banks (and to non-banks) on a proportionate basis.

## RISK DATA AGGREGATION AND REPORTING

In January 2013 the Basel Committee published 14 Principles on the aggregation and reporting of risk data.

The Principles cover:

- The importance of Boards and senior management exercising strong governance over a bank's risk data aggregation capabilities, risk reporting practices and IT capabilities. This includes
  - the documentation, validation and robustness of these capabilities and processes;
  - the design, build and maintenance of data architecture and IT infrastructure to support risk data aggregation capabilities and risk reporting practices both in normal times and during periods of stress.
- The accuracy, integrity, completeness, timeliness and adaptability of aggregated risk data. This includes
  - the adequacy of the systems and controls that generate risk data and its aggregation; and
  - the capability to adapt rapidly to changes in key risks and regulatory requirements.
- The accuracy, comprehensiveness, clarity, usefulness, frequency and distribution of risk management reports, including to the Board and senior management. This includes
  - procedures for monitoring the accuracy of data and model reliability;
  - making good use of forward-looking assessments of risk; and
  - reviewing the usefulness of risk management reports to senior management and the board.
- The need for supervisors to review and evaluate a bank's compliance with these principles, to take remedial action as necessary, and to cooperate across home and host supervisors.

### Banks' self-assessment against the principles

The Basel Committee published in December 2013 a self-assessment by 30 G-SIBs of their progress in meeting the risk data aggregation and risk reporting principles.

The results show that the three principles with the lowest reported compliance related to data aggregation: data architecture and IT infrastructure, the accuracy and integrity of data, and adaptability. Nearly half of the banks reported material non-compliance on

these principles, and many reported that they are facing difficulties in establishing strong data aggregation processes, and are therefore having to resort to extensive manual workarounds.

Banks self-assessed the highest compliance on the principles relating to the reporting of risk data: report distribution, and the comprehensiveness, clarity and usefulness of reports.

However, the Basel Committee found it odd that risk data reporting scored better than governance, since the governance principles should be preconditions to ensure compliance with the other principles; and that some banks rated themselves fully compliant on comprehensiveness but materially non-compliant on one or more data aggregation principles. This raises a question as to how reliable and useful risk reports can be when the data within these reports and the processes to produce them have significant shortcomings.

The Basel Committee concluded that banks need in particular to:

- Upgrade significantly their risk IT systems and governance arrangements, with an emphasis on formal and documented risk data aggregation frameworks, comprehensive data dictionaries that are used consistently by all group entities, comprehensive policy governing data quality controls, and controls at each stage of the life cycle of data;
- Improve the accuracy, completeness, timeliness and adaptability of their risk data, with less reliance on manual processes, and quality checks on risk data that are as robust as those supporting accounting data; and
- Generate relevant data on a timely basis to meet evolving internal and external risk reporting requirements.

These self-assessment findings are reinforced by the conclusions of the Senior Supervisors Group, published in January 2014, which examined the quality of banks' large exposures data. The Group found that banks' progress towards the consistent, timely and accurate reporting of large exposures failed to meet both supervisory expectations and industry best practice.



## DATA AND REPORTING

### What are banks doing?

#### Risk data

Many banks are struggling to meet all these Principles, although the extent of the gap will depend on how stringently the Principles are interpreted by national supervisors. In Germany and Italy, the Principles have already been incorporated into legislative requirements on the minimum standards for banks' risk management, and into the areas to be considered as part of the end-year audit.

#### / Banks should be reviewing:

- The quality and harmonisation of the risk data they collect;
- Their ability to aggregate risk data effectively, including across legal entities within a banking group;

- The use of IT to streamline data management and to make it more efficient – it will be too expensive to rely on manual processes and work-arounds;
- Bringing together risk and finance data;
- The internal reporting of aggregated risk data, including to senior management and the Board, and the use of this information for decision-making; and
- Governance (at Board and senior management level) procedures for risk data aggregation and reporting, including a bank's IT capabilities in these areas.

Many large banks are currently at the gap analysis stage of self-assessment, identifying areas where they need to

make improvements. The design and implementation of the necessary improvements will follow, much of which will require large-scale and expensive projects to introduce a new IT infrastructure. These projects will need to be integrated with related initiatives in areas such as corporate governance and risk governance, stress and scenario testing, management information, IT enhancements and external reporting (both to regulators and to other stakeholders). These enhancements will then need to be supplemented by the provision of assurance through external reviews of data management, data aggregation and data reporting.

### RISK DATA AGGREGATION AND REPORTING: FROM PRINCIPLES TO ACTIONS



- |   |   |
|---|---|
| ① Governance                              | ⑧ Comprehensiveness                         |
| ② Data architecture and IT infrastructure | ⑨ Clarity and usefulness                    |
| ③ Accuracy and Integrity                  | ⑩ Frequency                                 |
| ④ Completeness                            | ⑪ Distribution                              |
| ⑤ Timeliness                              | ⑫ Supervisory review                        |
| ⑥ Adaptability                            | ⑬ Remedial actions and supervisory measures |
| ⑦ Accuracy                                | ⑭ Home/host cooperation                     |

#### IT ARCHITECTURE

- Risk data models unified or automatically reconcilable across banking group with unified naming conventions
- Unified level of detail of data across the group to enable fully flexible reporting
- Risk and accounting data to be reconciled
- High degree of automation for risk data aggregation
- Strive for single source of risk data for each risk type

#### DATA QUALITY FRAMEWORK

- Effective data quality management including automated measurement methods and escalation procedures
- Comprehensive data governance for risk data including data owners from business and IT
- Documentation of reporting and reconciliation processes
- Automatic and manual quality checks in the reporting process

#### RISK REPORTING

- Adaptable and ad hoc reporting capability with drill-down into various risk dimensions, stress testing
- Comprehensive, timely, dependable and adaptable risk reporting capability across all units and all material risks

#### ORGANISATIONAL AND IT MANAGEMENT

- Risk reporting and aggregation to be mapped into IT strategy/ implementation roadmap
- Independent validation of standard compliance
- Full business continuity capability for risk reporting

Many banks will struggle to deliver the required improvements within the deadlines set by the Basel Committee, given the need to redesign systems. This may crowd out other systems and IT improvements for banks' strategic and commercial purposes.

### Exploiting data

Banks hold vast amounts of data, but these data are usually held in multiple forms and places that do not communicate effectively with each other or with central data processing centres. As a result, banks find it difficult to gather and exploit data on their customers. This in turn makes it difficult for banks to connect effectively with their customers; to identify profitable areas of business (by products, customers, business lines and geographies); and to drive simplification.

**Banks need to exploit better the technological advances that are enabling more effective customer profiling in both the retail and wholesale sectors.**

Indeed, the disconnect between banks and their customers may be widening, not least relative to rising customer expectations based on their experiences with firms in other industries who have performed better than the banking industry in using technological advances to understand their customers better and to communicate more effectively with them.

**Banks therefore need to extract more value from their data, not only to deliver against their aspirations to become more customer-centric and less product-driven, but also to remain competitive both with other banks and with potential new entrants to banking markets.**

The real competitive advantage here will come from the successful integration and analysis of all sources of customer and market data to develop a better understanding of customer needs and thereby to enable banks to serve these customers more effectively, efficiently and profitably.

But even if banks begin to place more value on data and invest more in data analytics, they will remain constrained by their IT infrastructures. These infrastructures are typically characterised by multiple disparate, aging and increasingly unreliable systems that have been stitched together during a period of mergers and acquisitions, entry into new areas of business, and a poorly managed series of IT enhancements in different areas of a bank's business.

**The IT infrastructure of many banks requires immediate and expensive attention from a group-wide perspective before it becomes wholly unsustainable – as is demonstrated by the increasing frequency of system outages.**

The pressure is growing on banks to break out of this unfortunate state of affairs, not least because banking is increasingly a technology business, and many of the potential competitors of banks may come from firms who are much more adept at technology, at the exploitation of customer data, and at providing high levels of customer service.

Harnessing technological advances would enable banks to:

- Streamline their operations and reduce operating costs;
- Connect better with existing and new customers across a multitude of existing and emerging communication channels, thereby enhancing customer satisfaction and loyalty;
- Build better defences against the rising threat of cyber crime (be it internal or external attempts to siphon funds from the bank or 'denial of service' attacks from various potential sources);
- Introduce greater industrialisation of processes in order to simplify, standardise and consolidate operations and thereby to reduce complexity, reduce costs and enhance customer service;
- Introduce automated smart systems which may provide at least part of the solution to a number of AML, tax and trading concerns, and may provide scope to transform compliance and internal;
- Reduce the costs – be they financial, regulatory or reputational – that emerge eventually from poor data and IT systems, not least because these poor data and IT systems facilitate bad decision-making and inappropriate behaviours; and
- Contribute effectively to the moves in some countries towards a new core banking system.

Equally, however, the familiar concerns remain. The up-front costs of IT and data projects arise at a time when banks' profitability is weak and pressures for cost reduction are strong. Banks need to decide how much change to introduce – shortcomings need to be addressed, but the search for perfection raises the spectre of costs exceeding benefits. And regulatory reporting requirements are already crowding out other IT and data projects.

### Impact on customers

If banks are successful in making better use of customer data there should be benefits for customers from banks designing, marketing and distributing products and services in ways that better meet customer needs; improvements in the ease of interaction with banks; and faster and more accurate levels of service.

Meanwhile, investors should benefit from bank disclosures that make it easier to understand the risks that banks are taking, how they measure and manage these risks, and how much capital they hold against these risks.

But there is also a cost point here – banks need to spend substantially on systems over next three to five years. There may be a payback eventually, but the up-front costs will be borne by customers and shareholders. ■



**Banks need to exploit better the technological advances that are enabling more effective customer profiling in both the retail and wholesale sectors.**

*'Risk comes from not knowing what you are doing.'*

Warren Buffett

# 05 Risk Governance

**A key lesson of the financial crisis was that the governance of many banks was ineffective, resulting in poor quality decision-making and poor quality oversight of risk by bank Boards.**

**Fundamental change is required across all aspects of risk governance. Standard setters have begun to define what good risk governance looks like, while banks have begun to move towards higher governance standards.**

**But in many banks this remains unfinished business.**

**B**anks need to do more in the area of risk and governance. New risk management and risk reporting procedures are being introduced, but roles and responsibilities have not always been fully determined, leading to both underlap and overlap. Many banks need radically different management information which only significant investments in core and critical systems will provide. And most banks have not yet reached a stage where their risk management function is genuinely strategic and forward-looking.







## SOUND RISK GOVERNANCE PRACTICES

A thematic review undertaken by the FSB of 36 banking groups across the G20 area showed that these firms had made improvements since the financial crisis in risk governance, not least in:

- Assessing the collective skills and experience of the Board;
- Undertaking more frequent and more demanding Board effectiveness reviews;
- Instituting a stand-alone risk committee; and
- Establishing a group-wide CRO.

However, these groups had made less progress in:

- Establishing and implementing a clear risk appetite statement;
- Defining the responsibilities of the risk committee and its interactions with the audit committee; and
- Strengthening risk management functions, in particular IT infrastructure and the ability to aggregate risk data efficiently and effectively. The review drew a clear link

here to the Basel Committee principles on risk data aggregation and reporting.

The FSB used examples of good practice to develop a set of sound risk governance practices for banks to aspire to, and for national authorities to use as a basis for assessing risk governance in major financial institutions. The FSB also recommended that international standard setters and national authorities should adopt more consistent approaches and should toughen their standards to reflect these sound risk governance practices.

The sound risk governance practices identified by the FSB include:

- The independence and expertise of the Board;
- The role of the Board in establishing and embedding an appropriate risk culture throughout the firm;
- The membership and terms of reference of the risk and audit committees;

- The reporting lines of the CRO (direct to the CEO, not through the CFO) and a distinct role from other executive functions and business line responsibilities;
- The importance of CRO involvement in all significant group-wide risks (including treasury and funding) and in key decision-making processes from a risk perspective (including strategic planning, acquisitions and mergers);
- The independence, authority and scope of the risk management function; and
- The independent assessment of the risk governance framework, including both an enhanced role for internal audit and the use of external third parties.

The review found significant gaps in all the banking groups in its sample, so banks should not assume that they are performing well against these criteria.

### Regulation and supervision

Since the financial crisis, many national authorities have strengthened their rules and guidance on corporate governance and risk governance, reflecting both local initiatives and new international standards from the FSB, the Basel Committee and the OECD.

New rules and guidance have typically included requirements on banks to:

- Undertake more detailed Board oversight of risk and risk management;
- Strengthen the composition of the Board and its sub-committees, including the independence, expertise, time commitment and diversity of non-executive directors;
- Clarify individual responsibilities and accountability;
- Establish a risk committee of the Board;
- Enhance the risk management function and the role of the Chief Risk Officer (CRO), in terms of independence, expertise, stature, authority and scope; and
- Undertake independent assessments of the bank's risk governance framework, through Board effectiveness reviews, internal audit assurance reviews and third party assessments.

Meanwhile, supervisors have increased their supervisory efforts by engaging more frequently and intensively with the Boards and senior management of banks. This has included more frequent and intensive on-site reviews of risk governance, including meetings with non-executive directors. They

are also requesting enhanced reporting on banks' risk management practices, including information on exposure limits, stress testing, Board and sub-committee minutes, and reports on risk governance from external auditors and other third parties.

However, the implementation of these initiatives has been uneven, both across national supervisors and across banks. Some of the most stringent reforms have been in Ireland, which has introduced new rules on corporate governance for banks and insurers. In the UK, recent legislation has introduced a new senior management regime to strengthen individual accountability at the most senior level in banks, shift the burden of proof when conduct or prudential failings arise at banks, and introduce a criminal offence of misconduct by senior bank management. In Germany, minimum standards for risk governance have been introduced (based on earlier EBA guidelines), requiring all banks to check that they fulfil all their regulatory, tax and accounting obligations and that large banks appoint a Board member to be responsible for compliance. And banks in Italy have to self-assess themselves against rules based on the EBA guidelines.

Based on these regulatory and supervisory developments, and on a review of risk governance practices in major banking groups, the Financial Stability Board (FSB) published in February 2013 a set of sound risk governance practices (see box), focusing in particular on the role of the Board and the role of non-executive directors; the group-wide risk management function and

the role of the CRO; and the independent assessment of risk governance.

CRD4 also contains a set of corporate governance requirements, which focus primarily on:

### Roles and responsibilities of the Board and its committees

The Board should approve and oversee strategy, risk strategy and internal governance, and there should be independent risk and remuneration committees, composed entirely of non-executive directors.

**Board composition** – There should be limitations on the number of directorships which may be held by members of the Board at any one time; a separation of the roles of Chairman and CEO; and appropriate Board skills, diversity of experience, honesty and integrity.

**Remuneration** – Banks should set a remuneration policy which is consistent with sound and effective risk management and business strategy. Individuals in compliance and risk management should be remunerated appropriately and independent of the performance of the business they control. Variable remuneration should be assessed on a multi-year framework, guaranteed variable remuneration should be avoided except in exceptional circumstances, and variable remuneration should not be more than 100 percent of base salary (unless a figure of up to 200 percent is agreed by shareholders).

## Many banks will struggle to meet the Principles for an effective risk appetite framework, in particular with respect to defining a risk appetite for non-financial risks; setting risk limits across business units and entities; and embedding risk appetite within a wider risk culture.

In November 2013 the FSB extended its guidelines on risk governance with two further papers: a set of Principles for an effective risk appetite framework (see box below), and a consultative document on Guidance to supervisors on assessing the risk culture of financial institutions (see box on page 48).

Many banks will struggle to meet these Principles for an effective risk appetite framework. Banks are already grappling with the challenge of robustly defining a risk appetite for non-financial risks; setting risk limits across business units and entities; and embedding risk appetite within a wider risk culture.

Meanwhile, for many banks the implementation by supervisors of the Guidance on assessing risk culture will represent a significant increase in supervisory intensity, and a shift in the direction of supervision into areas that some supervisors may not have focused on in the past. This will be even more pronounced if this approach to supervision extends down into D-SIBs and beyond. For example, the Bank of Italy issued in July 2013 a substantial update of the rules for the banking sector, including a requirement

on banks to define and implement a risk appetite framework.

**This increased supervisory interest in risk culture will require banks to demonstrate that they have:**

- Embedded a clear set of values and culture at all levels of the organisation;
- Learnt from risk culture failings;
- Clearly allocated risk ownership;
- Encouraged internal challenge to perceived poor behaviours; and
- Implemented a remuneration framework that genuinely reflects performance against compliance and risk management.

As with corporate governance more generally, progress on developing global standards for risk governance may not result in consistent calibration and implementation across jurisdictions. It is not clear to what extent monitoring through country and peer reviews by the FSB and the Basel Committee will deliver greater consistency, given the complexity and diversity of large banks and different national supervisory approaches.

## RISK APPETITE FRAMEWORK

The FSB's Principles for an effective risk appetite framework recognise that the concept of risk appetite was not always well understood, quantified or embedded in business management. The Principles state that the framework should:

- Be driven by both Board leadership and the involvement of management at all levels;
- Be communicated, embedded and understood across the bank, including being embedded into the bank's risk culture;
- Act as a brake against excessive risk-taking;
- Allow for the risk appetite statement to be used as a tool to promote robust discussions of risk and as a basis upon which the Board, risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;
- Cover subsidiaries and third party outsourcing suppliers that may be outside the direct control of the bank; and
- Be adaptable to changing business and market conditions.

The FSB then define the three key elements of an effective risk appetite framework as:

→ A risk appetite statement that:

- Is linked to the bank's short- and long-term strategic, capital and financial plans;
- Establishes the amount of risk the bank is prepared to accept in pursuit of its strategic objectives and business plan, taking into account the interests of its depositors and shareholders as well as capital and other regulatory requirements;
- Determines for each material risk the maximum level of risk that the bank is willing to operate within, based on its risk appetite, risk capacity, and risk profile;
- Includes quantitative measures that can be translated into risk limits applicable to business lines, legal entities and groups;
- Includes qualitative statements for risks that are not easy to measure, including reputational and financial consequences of poor management of conduct risks across retail and wholesale markets;
- Ensures that the strategy and risk limits of each business line and legal entity align with the bank-wide risk appetite statement; and
- Is forward looking and subject to scenario and stress testing to ensure that the bank understands what events might push the bank outside its risk appetite and/or risk capacity.

→ Risk limits that interact with the risk appetite because they:

- Constrain risk-taking within risk appetite;
- Are established for business lines and legal entities, and include material risk concentrations at the firm-wide, business line and legal entity levels (e.g. counterparty, industry, country/region, collateral type, product);
- Do not default to regulatory limits, and are not overly complicated, ambiguous, or subjective; and
- Are monitored regularly.

→ A set of supporting roles and responsibilities – the Principles include detailed job descriptions that outline the roles and responsibilities of the Board and senior management with respect to the risk appetite framework.



## ASSESSING RISK CULTURE

The FSB's proposed Guidelines are intended to support supervisors in taking a judgemental, outcomes-focused and forward looking approach. Supervisors should understand an institution's risk culture, in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework. To achieve this, supervisory interaction with Boards should be stepped up, based on high-level sceptical conversations with the Board and senior management on the bank's risk appetite framework, and on whether the bank's risk culture supports adherence to the agreed risk appetite.

Supervisors will be expected to focus on four key 'risk culture indicators', looking in particular for behaviours or attitudes that are not supportive of sound risk management, and intervening early to address these culture observations and thereby the potential build-up of excessive risk.

The four indicators are:

→ **Tone from the top** – how the bank's leadership ensures that its core values are communicated, understood, embraced and monitored throughout the organisation. This includes leading by example, assessing the impact of the high level values on behaviour throughout the organisation, ensuring common understandings of risk, and learning from risk culture failures;

→ **Accountability** – a clear allocation of risk ownership, escalation processes, and internal enforcement procedures;

→ **Effective challenge** – encouraging challenge and dissent, and organising the risk functions to provide access of risk and compliance to senior management and the Board; and

→ **Incentives** – basing remuneration on adherence to risk appetite and to desired cultures and behaviours, and appropriate talent development and succession planning.

**In many major banking groups there has been a significant shift in the relative importance of the business units and risk management.**

### What are banks doing, and what more do they need to do?

Banks have made progress in improving governance and risk governance, but most banks need to make further progress in these areas.

#### Focus on risk

At Board level, more attention is now being focused on understanding risk, on setting risk appetite, and on controlling, measuring, monitoring and reporting risk. This includes a reinforcement of the Board with non-executive directors who bring a deeper experience and expertise of banking and risk management; a more active role for the Board risk committee; a closer consideration of risk maps and risk related management information; and a more active role for the CRO in discussing risk with the Board risk committee and/or the Board itself.

However, at many banks the shift from the pre-crisis problem of inadequate and fragmented oversight – with information not being properly reported upwards from overly-independent business divisions – to much improved group-wide risk data being reported to the Board on a timely basis, remains incomplete. This relates closely to the problems in risk data aggregation and reporting discussed in Chapter 4.

As the volume and nature of internal and regulatory risk reporting grows many banks will need to invest further in risk data, systems, and architecture.

Meanwhile, the localisation agenda and the need to place additional emphasis on specific risks such as liquidity, conduct and reputational risk will make it even more challenging for a CRO, senior management and the Board to form a group-wide view of the risk profile and to manage the global business across regional, national, product and legal entity lines. As the cost of capital and funding increases there will also be an increasing need to consider the risk adjusted return on particular products and services.

Banks also need to consider how risk governance adds value within the organisation and to define clearly the role and mandate of functions and individuals with regard to risk management responsibilities.

Given all these responses to regulatory and other pressures, many Boards have asked whether they have sufficient time to consider strategic and commercial decisions.

### Oversight and accountability

Banks are beginning to respond to pressures from their supervisors to provide real clarity of accountability across core business activities and processes. This requires end-to-end oversight and ownership of these activities and processes. However, senior management in many banks have struggled to agree such accountability.

Banks need to develop and implement the necessary ownership of, and accountability for, their core business activities and processes. And they need to reach a position where they can attest with confidence to the clarity and effectiveness of these roles and responsibilities.

#### Role of the CRO

Many banks have reviewed and revised the role, responsibilities and reporting lines of the CRO, and in doing so have generally enhanced the CRO function. In line with the FSB guidelines, CROs increasingly report directly to the CEO rather than through the Chief Financial Officer (CFO), and have much greater access to the Board and the Board risk committee.

However, in some banks this remains work in progress, with issues still to be resolved around:

- How a CRO can establish a genuinely group-wide view of risk, in particular with respect to (i) the capital, funding and liquidity issues that have traditionally been the responsibility of the CFO; and (ii) the operations of a bank – be they specific business activities or geographies – that have traditionally been managed independently;
- How banks can establish an enhanced group-wide view of risk alongside the local view of risk that continues to be required by many national regulators; and how banks can meet the strategic challenge of having to balance centralised group risk management, decision making and control with the need to demonstrate that the local Board of each regulated entity remains accountable for the viability, sustainability and resolvability of that entity.
- The bifurcation of reporting (and the consequent need for some form of matrix management) between business lines and risk management, at all levels of a bank, including reporting to the Board; and
- The capacity and ability of CROs – and the risk management function more generally – to take a forward-looking and strategic view of risk. There needs to be a strong proactive view of risk, not just a reactive and backward-looking monitoring of limits and procedures.

### Risk management

In many major banking groups there has been a significant shift in the relative importance of the business units and risk management. More risk management is now embedded in the 'first line of defence' (the business units), which has shifted from being almost entirely revenue-driven to being more risk constrained and obligation-driven. Some banks have also restructured the second and third lines of defence, with the second line (including risk management) becoming more dominant, more powerful, and more centralised; and with an enhanced third line (including internal audit) to provide more robust assurance that systems and controls are operating effectively.

However, risk management remains under-resourced in some banks, and in some cases the shifts in the first and second lines of defence are far from smoothly embedded.

**A renewed focus on an effective three lines of defence approach to risk management may call for further investment and up-skilling within the first line, while an independent second line refocuses its priorities around advice, framework design, effective challenge and risk aggregation to identify concentrations and correlations across the bank. Regulatory reforms designed to improve the independent assessment of the effectiveness of risk governance may also call for significant investment and up-skilling in the third line, to provide positive assurance on the effectiveness of risk policies, processes and controls. ■**

**At many banks the shift from the pre-crisis problem of inadequate and fragmented oversight – with information not being properly reported upwards from overly-independent business divisions – to much improved group-wide risk data being reported to the Board on a timely basis, remains incomplete.**

# Abbreviations

<b>AML</b>	Anti-Money Laundering
<b>AQR</b>	Asset Quality Review
<b>BAFIN</b>	Federal Financial Supervisory Authority in Germany
<b>BRRD</b>	Bank Recovery and Resolution Directive
<b>CCPs</b>	Central Counterparties
<b>CEO</b>	Chief Executive Officer
<b>CET1</b>	Common Equity Tier 1
<b>CFO</b>	Chief Financial Officer
<b>CFTC</b>	Commodity Futures Trading Commission
<b>COREP</b>	Common Reporting Framework
<b>CRD</b>	Capital Requirements Directive
<b>CRO</b>	Chief Risk Officer
<b>CRR</b>	Capital Requirements Regulation
<b>D-SIB</b>	Domestic Systemically Important Bank
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>EMA</b>	Europe, Middle East and Africa
<b>EMIR</b>	European Market Infrastructure Regulation
<b>ESAs</b>	European Supervisory Authorities
<b>ESMA</b>	European Securities and Markets Authority
<b>EU</b>	European Union
<b>FATCA</b>	Foreign Account Tax Compliance Act
<b>FCA</b>	Financial Conduct Authority
<b>FSA</b>	Financial Services Authority (UK)
<b>FSB</b>	Financial Stability Board
<b>FTT</b>	Financial Transaction Tax
<b>G-SIB</b>	Global Systemically Important Bank
<b>LCR</b>	Liquidity Coverage Ratio
<b>LIBOR</b>	London Interbank Offered Rate
<b>MiFID</b>	Markets in Financial Instruments Directive
<b>MiFIR</b>	Markets in Financial Instruments Regulation
<b>NSFR</b>	Net Stable Funding Ratio
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>PPI</b>	Payment Protection Insurance
<b>PRA</b>	Prudential Regulation Authority
<b>SRM</b>	Single Resolution Mechanism

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