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cutting through complexity

# Evolving Banking Regulation Part Two

## Bank Structure: The Search for a Viable Strategy

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# Contents



## Evolving Banking Regulation – Part One


This publication is the second part of the *Evolving Banking Regulation* series for 2015. The first part outlined the multiplicity of regulatory pressures on banks.

This second part focuses on bank structure, and the **search by many banks for a viable and sustainable future** in a world where regulatory and commercial pressures are driving business model change.

Future issues of *Evolving Banking Regulation* will be published in the coming months and will focus on conduct and culture, data and cybersecurity, and supervision.

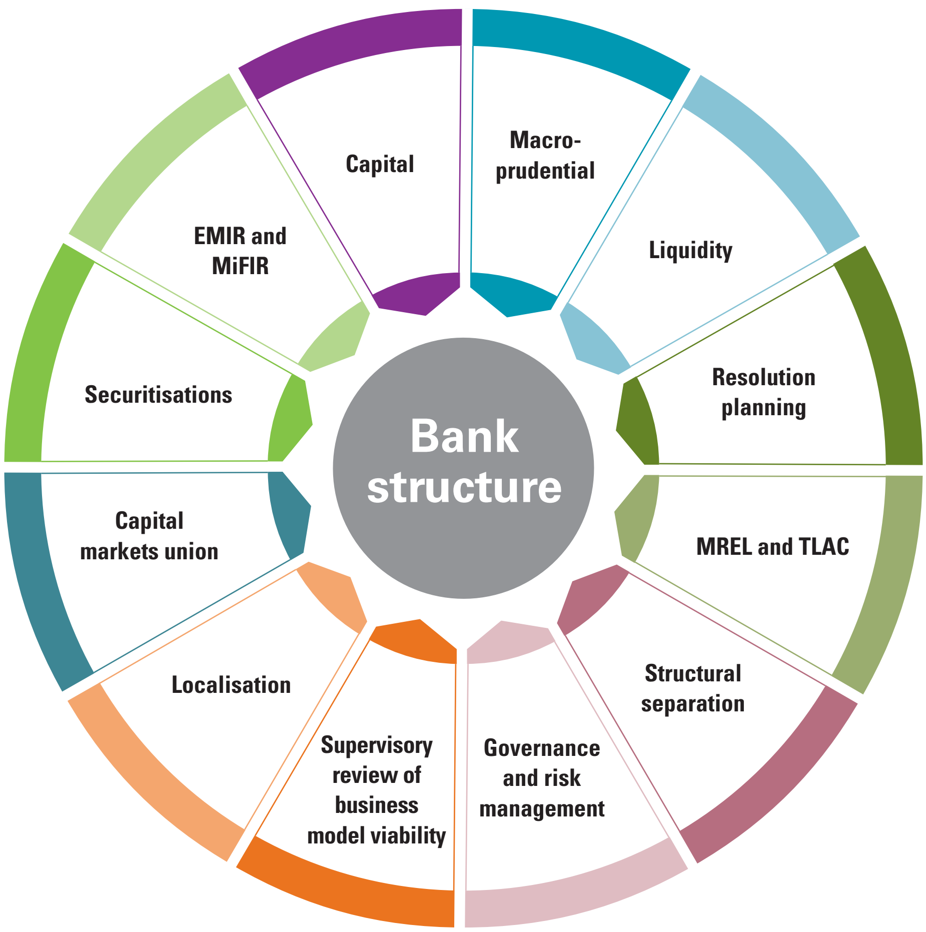
# Executive Summary

The **regulatory pressures on bank structures** include higher costs of doing business (higher minimum requirements for capital, leverage, eligible bail-in liabilities, liquidity, risk governance, and the trading, clearing and reporting of derivatives); constraints on balance sheet composition, business activities, and legal and operational structure; and supervisory intervention in banks' business models and strategy.

Banks also face a variety of **economic and commercial pressures**, including the weak economic environment, low interest rates, market over-capacity, strong competition, technological change, low margins and high cost bases.

Together, these pressures are **driving changes in bank structure**. Some of the commercial and operational synergies on which many bank business models were based are being undermined by these pressures, especially at universal and cross-border banks. Many of their

**Regulatory pressures on bank structure**




Source: KPMG International 2015

strategic assumptions are increasingly out of date – **the rules of the game have changed and the business model needs to change accordingly.** There are four key dimensions to this change:

1. **Product and customer propositions and pricing;**
2. **Balance sheet** size and composition, and capital planning;
3. **Legal structure,** across types of business and across jurisdictions; and
4. **Operational structure,** including governance, management, organisational structure, risk management and compliance, distribution channels, payment and settlement arrangements, trade and other transaction booking, and the provision of services to support critical economic functions.

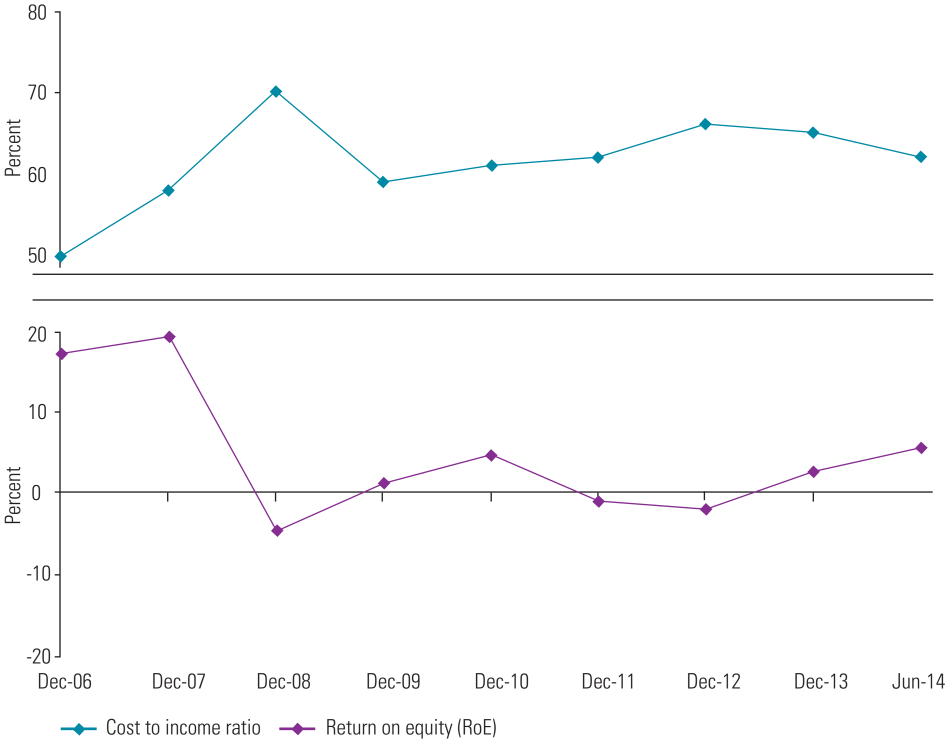
Changes in bank structure have taken many forms. Initially post-financial crisis, banks focused on **improving their capital positions**. They retained earnings and – where and when possible – raised new capital. And, particularly in Europe, banks **reduced their balance sheets and their risk exposures** by pulling out of non-core, sub-scale and insufficiently profitable activities, retrenching from overseas businesses, and reducing their trading positions.

Smaller balance sheets also made it easier for banks to **reduce their reliance on short-term wholesale funding**, and to increase the proportion of customer deposits within their liabilities.

However, this balance sheet restructuring has not increased the **very low returns on assets and returns on equity** of many European banks, and their cost to income ratios have risen (as their costs have fallen by less than their income). Many banks are struggling to cover their cost of capital, even as regulation increases the required quantum and quality of capital. And the new regulatory requirements for liquidity are increasing the maturity and cost of their non-capital funding.

> "Balance sheet restructuring has not increased the very low returns on assets and returns on equity of many European banks."

**European banks struggling with high costs and low profitability**




Source: ECB consolidated banking data for all EU banks

Many banks therefore need to **develop and implement viable and sustainable business strategies in order to meet the expectations of their investors, regulators and customers**. This is proving a real challenge for these banks, particularly if they cannot rely on an eventual economic recovery and the opportunity to reduce non-performing exposures to bring their RoE up to at least their cost of equity.

Banks should also **reconsider their strategic direction**, their target markets and locations, their pricing of products of services, and their ability to reduce costs.

It is not clear that all banks will survive this process, and there are emerging signs of both market and supervisory **pressures to clear out some over-capacity in the banking sector**. The end result – as already seen in investment banking – could be a smaller number of larger banks, with implications for competition and banking concentration and for the systemic importance of these larger banks.

All this will also have **implications for the customers of banks**. A repositioning and repricing of products and services by banks may benefit some customers, but overall the result is likely to be that products and risk management services will become more expensive and less readily available for individual consumers, SMEs, large corporates and infrastructure financing.

**Banks need to respond to multiple pressures**

### Customers

- Fewer, more expensive, products and services
- Regulatory constraints on product and service offerings
- Less liquid securities
- Driven to alternative channels of intermediation

### Investors

- Looking for adequate returns
- Prepared to accept lower returns if risk is correspondingly lower
- Debt coupons will reflect threat of bail-in

### Regulators

- Banks and the financial system sounder and more stable
- Higher costs for banks and their customers
- Lack of trust in banks
- Promotion of non-bank sources of financing


Source: KPMG International, April 2015

# Regulatory pressures

## Overall impact on bank structure

Part one of this year's *Evolving Banking Regulation* set out the ever-widening range of post-crisis regulatory reforms. The main **regulatory drivers of bank structure** are:

- The proposed **EU Regulation on structural separation**, and related national legislation in Belgium, France, Germany and the UK;
- **Restrictions on banks' legal and operational structures** to meet recovery and resolution requirements;
- The impact of **capital, liquidity and loss absorbency requirements** on banks' asset and liability structures. Some banks' internal targets may not yet have caught up with the higher regulatory benchmarks for capital, funding, leverage and loss absorbency;
- **Higher costs**, resulting in the divestment or running down of no longer sufficiently profitable businesses and activities;
- **Local jurisdiction 'ring-fencing' requirements** (in the US, the UK and in some Asia Pacific countries) on internationally active banks to hold local capital, liquidity and loss absorbency, and to introduce more elaborate local governance and risk management arrangements. This increases the overall capital and liquidity requirements for international banking groups, restricts the fungibility of capital and funding across these groups, limits flexibility in the hedging and diversifying of risk, damages the viability of current client service models, and reduces the benefits of operating as an international banking group; and
- **Supervisory actions**, including those resulting from assessments of banks' business models and viability.

The balance sheet implications of regulatory reforms are illustrated in Table 1. These reforms increase the cost and constrain the flexibility of a bank's liabilities, and incentivise banks to hold less risky and shorter maturity assets.

## EU proposed structural separation measures

The European Commission proposed in January 2014 a Regulation on structural separation for EU banks. The two main proposals were:

- A ban on proprietary (own account, not client related) trading; and
- A structural separation power for competent authorities to prohibit a 'core' credit institution (a bank that takes deposits covered by a Deposit Guarantee Scheme) from undertaking trading activities. This would have to be applied if a bank's trading activities exceed a set of assessment metrics, and could also be applied if a bank's trading activities were judged by a competent authority to pose a threat to the financial stability of the bank or of the financial system as a whole. If this provision was applied, 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.

The final shape and details of any EU Regulation remain to be determined, with the European Parliament and Council still developing their positions.

Annex 1 provides more detail on these EU negotiations. It also **sets out a detailed analysis of why the costs of the EU's structural separation proposals are likely to exceed the benefits**, not least because of the significant potential adverse consequences of structural separation, because large-scale trading activities may remain systemically important, even if they are undertaken in a separate entity, and because the objectives of structural separation have already largely been achieved through other regulatory requirements.

### Table 1: Regulatory pressures on banks' balance sheets

**Assets**

| Assets | Regulatory pressures | Regulatory pressure for change | Impacts |
|---|---|---|---|
| HQLAs | • LCR | ↑↑↑ | • Low yielding<br>• Unattractive to banks facing leverage ratio constraint<br>• Shortage of eligible assets in some countries |
| Other securities | • Higher capital charges, margins and haircuts<br>• Structural separation and resolvability<br>• Leverage ratio (constraint on holdings of lower risk weight assets)<br>• NSFR constraints on securities financing transactions | ↓↓ | • Reduced secondary market liquidity, especially in corporate bonds<br>• Supervisory pressures on booking of trades across a banking group<br>• More expensive for customers issuing and trading securities |
| Interbank lending | • LCR and NSFR<br>• Large exposure rules, especially on SIBs<br>• Leverage ratio | ↓↓ | • Contraction in interbank market |
| Residential mortgage lending | • Higher risk weights on IRB model approaches<br>• Revised standardised approach<br>• Leverage ratio<br>• NSFR<br>• Lower capital charges on simple securitisations? | ↓ | • More expensive for borrowers<br>• Will margins be sufficient for banks to achieve a respectable return on equity? |
| Unsecured credit to households | • Limited impact of changes in sector-specific risk weights<br>• NSFR | ↓ | • More expensive for borrowers, especially where maturity above one year |
| Corporate lending | • Revised standardised approach for credit risk<br>• Tougher supervisory classification of non-performing loans<br>• Stress tests<br>• Simple securitisation proposals include SME lending<br>• Competition from non-banks and capital markets | ↓ | • More expensive for customers to borrow from banks<br>• Uneconomic for banks to lend to highest quality corporates |
| Infrastructure lending | • NSFR<br>• Potential leverage constraint if low risk weighted (e.g. government guaranteed) | ↓ | • Limited bank involvement in infrastructure lending |
| Off-balance sheet activities | • Leverage ratio<br>• Central clearing, exchange trading and reporting of OTC derivatives<br>• Structural separation proposals | ↓ | • More expensive for customers<br>• Reduced availability and higher cost of risk management products and services |

**Note:** The number of arrows indicates the extent of regulatory pressure. Upward arrows indicate regulatory pressure on banks to increase a type of asset or liability, while downward arrows indicate regulatory pressure on banks to reduce a type of asset or liability

## Liabilities

| Liabilities | Regulatory pressures | Regulatory pressure for change | Impacts |
|---|---|---|---|
| CET1 capital | • Higher minimum, buffer and macro-prudential capital requirements<br>• Higher risk weights and capital floor<br>• Stress tests<br>• Leverage ratio | ↑↑↑ | • Higher cost of funding, not fully offset by reduced cost of other liabilities<br>• Location of issuance increasingly constrained<br>• Local requirements for subsidiaries of international banks |
| AT1 capital | • Limited role of AT1 capital, but relevant if leverage ratio calibrated using total tier 1 capital | ↑ | |
| Tier 2 capital | • Diminished role of tier 2 capital, but important for TLAC and MREL requirements | — | |
| Other debt meeting TLAC and MREL requirements | • TLAC and MREL | ↑↑↑ | |
| Other medium and long-term wholesale funding (unsecured) | • LCR and NSFR<br>• Structural separation | ↑ | • Smaller banks may struggle to raise longer-term unsecured wholesale funding – high cost and limited availability<br>• Impact of structural separation on cost and availability of trading entity funding |
| Secured medium and long-term funding | • LCR and NSFR<br>• Capital requirements still evolving for issuers and holders<br>• Regulatory concerns over excessive asset encumbrance<br>• In EU, covered bonds attractive to other banks as HQLAs | ↑↑ | • Investors keen to hold secured liabilities to avoid threat of bail-in |
| Unsecured short-term wholesale (and large corporate) funding | • LCR and NSFR<br>• Tighter large exposure limits for lending between SIBs<br>• Possible use of wholesale funding as a criterion for setting capital buffers<br>• Regulatory pressure to reduce structural funding gaps | ↓↓↓ | • Contraction of short-term wholesale funding<br>• Higher cost of alternative sources of funding |
| Secured short term funding | • Capital, haircuts and NSFR constraints on securities financing transactions<br>• LCR constraint on very short term repo funding | ↓ | |
| Retail funding | • LCR and NSFR<br>• Depositors better protected under deposit protection schemes and creditor hierarchy in bail-in<br>• Structural separation and RRP pressures to move retail deposits into a separate and ring-fenced legal entity<br>• Moves to make IRRBB a Pillar 1 requirement<br>• Tougher consumer protection measures | ↑ | • More competition for retail deposits<br>• Shifts to less stable types of retail deposit will reduce the share of deposits that count for the most favourable (stable) LCR and NSFR treatments<br>• Higher cost to banks of retail deposits |

**Note:** The number of arrows indicates the extent of regulatory pressure. Upward arrows indicate regulatory pressure on banks to increase a type of asset or liability, while downward arrows indicate regulatory pressure on banks to reduce a type of asset or liability

> "The impact of these requirements on Belgian, French and German banks is likely to be limited to monitoring and reporting, rather than the closing or restructuring of trading activities."

## National legislation

Meanwhile, national legislation on structural separation has been implemented in Belgium, France, Germany and the UK, albeit with differences in approach across these countries.

In the UK, the Government has followed up the 2013 primary legislation with secondary legislation to specify in more detail the definition of core retail deposit-taking activities, of the banks (with more than £25 billion of core deposits from individuals and small businesses) that will be subject to ring-fencing requirements, and of the activities that ring-fenced banks will either be excluded from undertaking (including commodities trading) or will be allowed to undertake only under certain conditions (including a limited range of hedging and simple derivatives transactions).

The UK Government has also proposed legislation that would impose a systemic risk buffer of up to 3 percent of risk weighted assets in the form of CET1 capital on banks and building societies with core deposits of more than £25 billion.[1]

The Prudential Regulation Authority (PRA) has consulted on the detailed implementation of ring-fencing, including on the legal structure of groups containing a ring-fenced bank, the separate governance and risk management of a ring-fenced bank, and the continuity of services and facilities for ring-fenced banks from either intra-group entities or third parties outside the group. Other key areas are due to be covered by further PRA proposals during 2015, including on intra-group exposures between the ring-fenced bank and the rest of the banking group.

UK banks expecting to be subject to ring-fencing requirements were also requested by the PRA to submit by January 2015 a preliminary plan of their anticipated legal and operating structures, well ahead of the 2019 implementation date for ring-fencing.

In France, the French Banking Separation and Regulation Act (2013) – in force since 1 July 2014 – requires a separation between proprietary trading activities (above a minimum threshold amount) and retail banking activities. This separation will have to be effective from 1 July 2015.

French banks also have to provide information on their proprietary trading activities, including an annual detailed description of all trading activities performed and the internal control system set up in order to monitor risks related to those activities. In addition, even if market making activities are not banned and are not covered by any separation, these activities will be monitored closely by the French regulators.

From 1 April 2015 French banks will have to report indicators on market making activities on a quarterly and annual basis, including an annual report on market making activities, financial instruments and trading platforms, and quarterly data on volume of operations, market shares, bid-ask spreads, contributions to the daily P&L, and number of days of trading losses.

In Germany, banks are undertaking 'risk analyses' – for completion by the end of 2015 – to define which products are in scope under the national legislation and which not. Many banks have also set up proprietary trading compliance programmes because legislative restrictions on such trading are already in force.

In Belgium, legislation enacted in April 2014 requires banks to undertake their trading activities in a separate entity (which is not funded by insured customer deposits) if these activities exceed a certain threshold.

The impact of these requirements on Belgian, French and German banks is likely to be limited to monitoring and reporting, rather than the closing or restructuring of trading activities, not least because most banks had already scaled back their proprietary trading activities to below the relevant threshold levels.

1 Source: UK proposed statutory instrument January 2015: The Capital Requirements (Capital buffers and macro-prudential measures) (Amendment) Regulations 2015

## Recovery and resolution planning

Although the Bank Recovery and Resolution Directive (BRRD) **requires competent authorities in the EU to be given powers to require banks to implement changes to improve the credibility of banks' own recovery plans and the resolution plans that are owned ultimately by resolution authorities**, these powers have not been used extensively to date. Most major banks have formulated recovery plans that are consistent with the BRRD, without being required to implement structural changes.

On resolution planning, in the UK the PRA has focused on areas such as **legal entity rationalisation; ensuring the continuity of critical shared services for critical economic functions** (through a dedicated intra-group service company providing critical shared services to one or more regulated entities, or possibly an operational division providing critical shared services from within a regulated entity with attributes that would allow resolution authorities to implement a separate service company model should they need to); **valuation; a winding down plan for larger trading books; and the booking of trades across international banking groups**.

In Switzerland, both Swiss G-SIBs announced in the second half of 2014 that they are each establishing a new dedicated Swiss bank which will comprise the systemically relevant functions, in an effort to increase resolvability. This is a significant structural change, as the non-systemic activities will be continued in the current structure, separately from the new bank. **The banks must then demonstrate – in accordance with the Swiss Banking ordinance – that the new Swiss bank is able to continue operations without interruption**, without depending on the rest of the group. Similarly to the UK requirements, this includes the bankruptcy remoteness of service level agreements, the adequacy of the capital and other resources of shared services companies, and making sure that any inter-company arrangements and relationships between the new bank and the rest of the group do not lead to legal or financial barriers in resolution.

**Other countries have so far made less progress on resolution planning**, and have not yet required structural change to improve the credibility and effectiveness of resolution plans. However, the French resolution authority (the banking supervisor) has followed the US and UK preference for a single point of entry for bail-in debt, with the application of resolution measures at the consolidated level of a French banking group, and is considering the articulation of MREL and TLAC requirements in this context.

“Both Swiss G-SIBs announced in the second half of 2014 that they are each establishing a new dedicated Swiss bank which will comprise the systemically relevant functions, in an effort to increase resolvability.”

# Other pressures on banks

## Weak economic environment

In the euro area in particular, **weak (or even negative) economic growth has increased the level of non-performing exposures, reduced the demand for borrowing from banks, and made it more difficult for banks to increase their lending margins**. These demand-side pressures have reinforced the regulation-driven supply-side pressures on banks, with a resulting downward spiral of weak economic growth and weak bank lending.

The results of the Comprehensive Assessment may have boosted confidence in banks. It lifted some clouds over bank balance sheets, but not by enough to kick-start lending and economic growth. Indeed, it may have made some banks more risk averse, because a tougher approach to asset quality may have made banks less willing to lend and more likely to demand higher collateral and enhanced borrower repayment capacity to improve loan quality.

In the Middle East, the most immediate impact on banks of the fall in oil prices has been a reduction in the availability of low cost government deposits, forcing the banks to diversify their sources of deposits and putting downward pressure on banks' net interest margins.

## Non-performing exposures

**The AQR identified the need for major banks across the euro area to reclassify 18 percent of reviewed loans from performing to non-performing**, with the highest proportions of reclassifications in the large corporate, shipping, project finance and other non-retail sectors. This increased the non-performing exposures in the reviewed portfolios from €740 billion to €880 billion, and the total of these banks' non-performing exposures across all portfolios from €1.2 trillion to at least €1.35 trillion.

The capital required to support these total non-performing exposures is around €100 billion, equivalent to more than 10 percent of these banks' total capital. This is spread unevenly across the major banks, with particularly heavy concentrations of non-performing exposures in banks in Cyprus, Greece, Ireland, Italy, Portugal and Spain.

KPMG estimates that these exposures represent a downward drag of 1.5 percentage points on these banks' return on equity (comparing the estimated returns on the non-performing exposures with the returns that banks could potentially earn by deploying the capital supporting these exposures to other asset types).

## Low margins

EU banks' net interest margins have remained broadly unchanged (as a percentage of total assets) since before the financial crisis. In some respects this represents a reasonably strong performance, at a time when banks have generally shifted into lower risk (and lower return) loans and other assets, and when near-zero or even negative interest rates have imposed a lower bound on funding costs.

However, with other components of total operating income also remaining broadly unchanged, **this has left these banks vulnerable to the negative impact on profitability of higher non-funding costs**, including the impact of tougher regulation; higher loan losses and provisions, accentuated in the banking union by the AQR; and, for some banks, fines and redress payments relating to conduct (wholesale and retail) issues. Asset books built up by banks ahead of the financial crisis are now under-performing.

Margins have therefore been insufficient to prevent European banks from moving into weak or even negative profitability. Banks have also found it difficult to pass through higher lending margins (and higher prices of other products and services) because of weak demand and strong competition – especially competition for the most attractive assets and liabilities from both existing players and 'challenger banks', even during a period of general deleveraging.

## High costs

**Complying with ever more complex and extensive regulatory requirements has increased costs significantly, at a time when many banks are also struggling with the impact of the weak economic environment and falling revenues.**

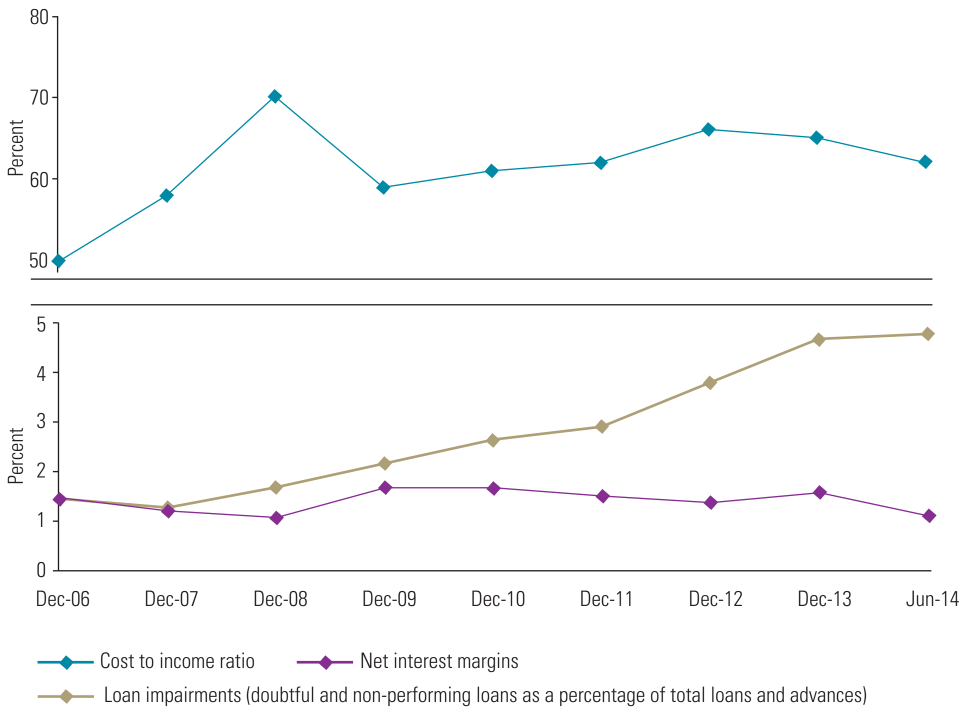
Despite efforts to reduce costs, cost to income ratios have risen at EU banks since the financial crisis – lower income from deleveraging and non-performing exposures has more than offset any reduction in costs.

This is in contrast to the reductions in cost to income ratios achieved (on average) by banks in other advanced countries: a global sample of banks analysed by the IMF[2] shows progress in reducing cost to income ratios, with cost to income ratios across the sample falling by 7 percentage points to 66 percent since 2008, bringing the ratio back into line with its 1995-2005 average of 65 percent.

Part of the problem at European banks is a failure to address bloated cost infrastructures built up ahead of the financial crisis. Within this, salary costs have remained remarkably impervious to falling profitability in many European banks, while regulation and litigation/remediation have driven up some other elements of cost.

"Part of the problem at European banks is a failure to address bloated cost infrastructures built up ahead of the financial crisis."

### European banks' costs and margins




Source: ECB consolidated banking data for all EU banks

2 IMF Global Financial Stability Report, October 2014.

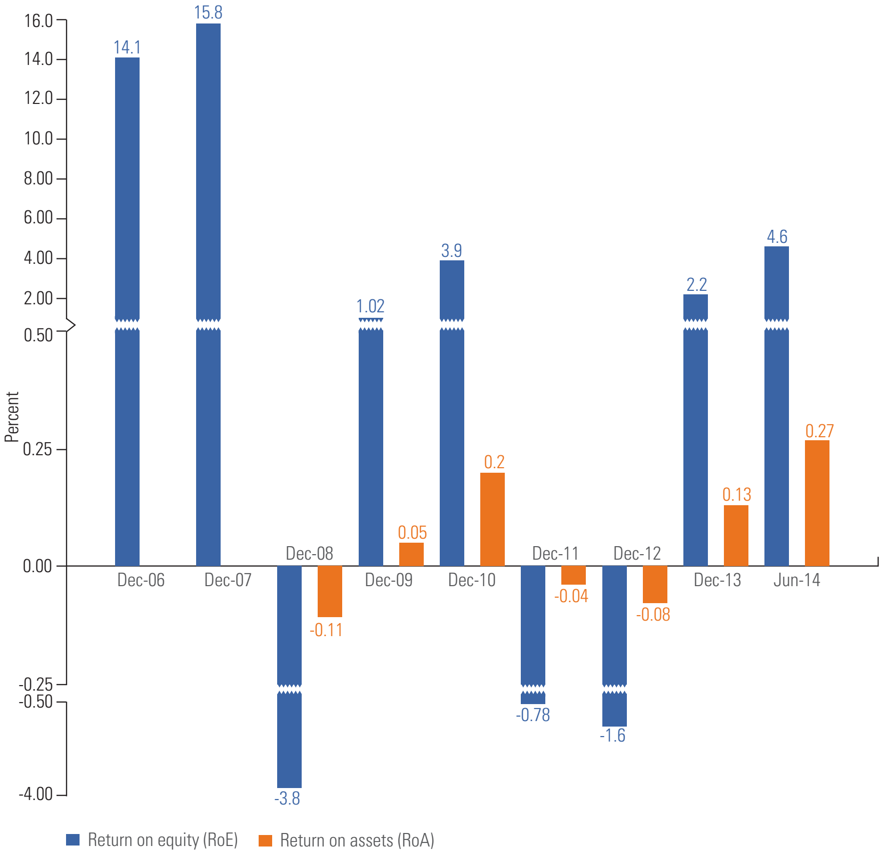
## IT and other system inefficiencies

Banks are paying the price of earlier under-investment in IT and other systems and processes. They are now faced with the **dual pressures of spending constraints on new investment and the multitude of demands to spend more on IT and systems** – regulatory reporting, data and risk management, enhancing the ability to make better use of 'big data' to drive pricing, customer service and strategic decisions, and the growing opportunities (and threats) from 'digitisation'.

## Return on equity (RoE)

**The regulatory and commercial pressures on banks come together in the very weak average RoE across European banks since the financial crisis.** The EBA Risk Assessment Report (December 2014) showed 76 percent of a sample of 57 major EU banks with RoEs of less than 8 percent, and 39 percent with an RoE of less than 4 percent. This is consistent with KPMG estimates based on Comprehensive Assessment data that 85 percent of the banks included in the Comprehensive Assessment were not covering the cost of their equity.

**European banks' return on equity and return on assets**




Note: RoA data starts in 2008
Source: ECB consolidated banking data for all EU banks

**This leaves these banks' return on equity well below estimates of the cost of equity.** Bloomberg estimates quoted in the IMF's Global Financial Stability Report put the cost of equity at 13 percent, although questionnaire results in the EBA's Risk Assessment Reports show the cost of equity falling slightly to around 10 percent: respondents were evenly split between a 10-12 percent range and an 8-10 percent range for the cost of equity in the EBA's December 2014 report, whereas in previous reports a majority of respondents had placed the cost of equity in the 10-12 percent range. This may reflect a perception among investors that European banks are becoming safer, although this has had only a modest impact on the cost of equity.

The gap between banks' return on equity and cost of equity may narrow somewhat if economic growth picks up, with a positive impact on non-performing exposures, loan losses and impairments, but for most banks with a shortfall this is unlikely to be sufficient to close the gap.

Updates of the KPMG in the Netherlands analysis of the cumulative impact of regulatory changes on the Dutch banking sector, based on a consolidated financial model for the six largest banks, show that under current and prospective regulatory requirements these banks could only generate a return on equity at least equal to their cost of equity through significant asset reductions, cost reductions and repricing.

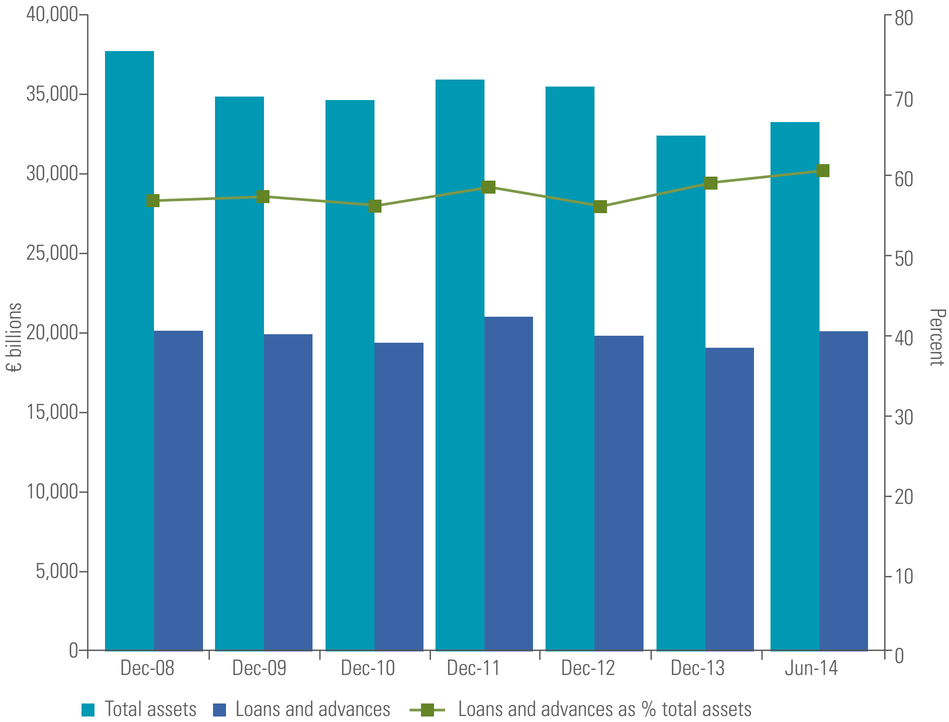
# What are banks doing?

## Balance sheet adjustment

Consolidated banking data for the EU show:

### Total assets, loans and advances

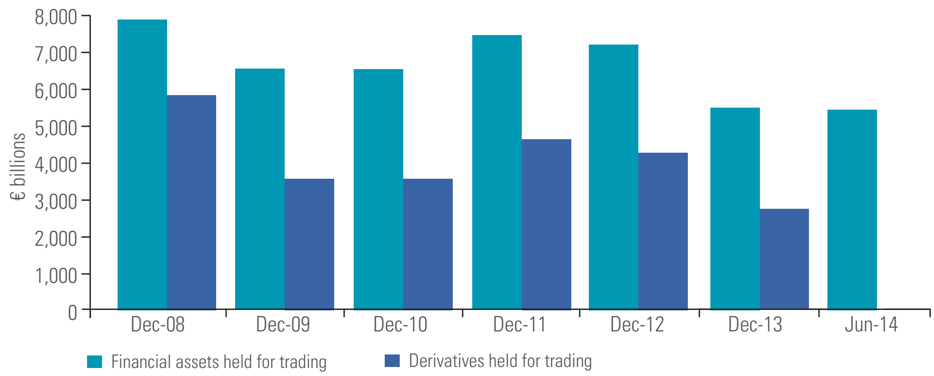
- European banks have re-focused on core activities and markets, and on domestic activities – many banks have retrenched selectively from international markets, both within the EU and especially from outside the EU
- Consolidation in the number of banks – 500 (10 percent) reduction in EU credit institutions since 2007
- Reduction in total assets of €4 trillion (11 percent) since the financial crisis began, compared with an overall increase of 8 percent in advanced economies between 2009 and 2012, and by 47 percent in emerging economies over the same period[3]
- Loans and advances flat, but increasing as a proportion of total assets
- Within loans and advances, increase in mortgage lending but fall in corporate lending
- Increased holdings of cash and sovereign debt
- Some signs of a pick-up in loans and advances in the first half of 2014




Source: ECB consolidated banking data for all EU banks

### Trading assets and derivatives

- Substantial reduction in financial assets held for trading (30 percent decline) and derivatives held for trading (50 percent decline) between 2008 and 2013 – this accounts for most of the €4 trillion reduction in total assets
- Shift by some banks to more fee-based and less capital intensive activities, including mergers and acquisitions, securities underwriting, and asset and wealth management

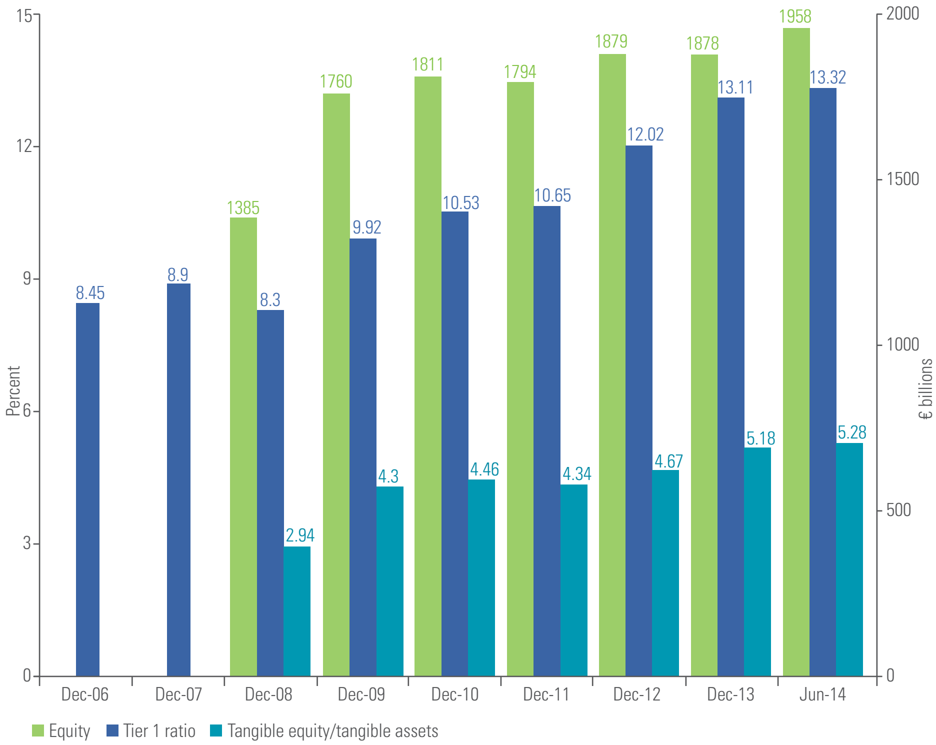



Note: Data for derivatives for June 2014 was not available.
Source: ECB consolidated banking data for all EU banks

3 "Banks and capital requirements: channels of adjustment," BIS Working Paper 443, March 2014.

## Capital ratios

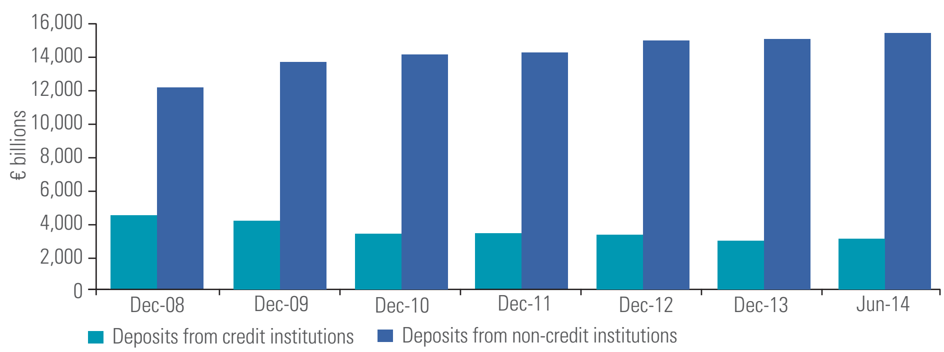
- Banks holding more equity capital
- Improvement in tier 1 capital ratios (up from 8.5 percent in 2006 to 13.3 percent in 2014)
- Decline in RWAs from combination of smaller balance sheets, expanding use of internal model based approaches for calculating capital requirements, and shift in asset composition to lower risk-weighted assets
- Improvement in leverage ratio through combination of higher capital and deleveraging
- But European banks different from those in other advanced economies – an analysis[4] of 94 major banks from across the globe shows that overall these banks increased their capital by 46 percent and increased their RWAs by 14 percent from end-2009 to end-2012. But the 35 European banks in this sample increased their capital by only 8 percent and reduced their RWAs by 11 percent.




Source: ECB consolidated banking data for all EU banks

## Deposits

- Substantial decline in deposits from other credit institutions
- Substantial increase in deposits from non-credit institutions
- So rising customer deposit to loan ratio and fall in wholesale funding




Source: ECB consolidated banking data for all EU banks

The picture is different for many banks in the Middle East, where difficult conditions in traditional domestic markets (relatively small populations, highly competitive markets for lending to large corporates, and problems in some large borrowers) have led to attempts to expand lending to SMEs, and to an expansion of overseas activity, including in support of trade between the Middle East and Turkey, Africa and Asia.

4 "Banks and capital requirements: channels of adjustment", BIS Working Paper 443, March 2014.

# What do banks need to do?

> Banks facing a large (negative) gap between return on equity and cost of equity need to consider a fundamental overhaul of their business models.

## The dimensions of a viable and sustainable business model

Banks are currently in different positions. But many of them **need to build a viable and sustainable business model, which delivers adequate returns, adequate capital and liquidity resources, and acceptable resolvability**.

Deleveraging and de-risking to meet higher capital requirements has not solved, and will not solve, the underlying problems faced by many banks, because this has had only a limited – or even a negative – impact on profitability. Banks facing a large (negative) gap between return on equity and cost of equity need to consider a fundamental overhaul of their business models.

Meanwhile, **the adequacy of capital and liquidity resources is by no means assured for many banks**. Even though only a small number of major European banks 'failed' the Comprehensive Assessment, this assessment did not take full account of additional pressures on banks' capital from:

- The 'fully loaded' version of Basel 3/CRR, including the full phasing in of all requirements;
- Further tightening of capital requirements, including through proposed revisions to the calculation of risk weighted assets; the final national calibrations of the systemic risk buffer and capital surcharges on D-SIBs; the use of other macro-prudential policy instruments; and tougher approaches to the setting of Pillar 2 capital requirements;
- Leverage ratio constraints – the Comprehensive Assessment results show that post-AQR, 17 banks had a leverage ratio of below 3 percent, a further 10 between 3 and 3.5 percent, and a further 12 between 3.5 and 4 percent (again before the full loading of adjustments to banks' tier 1 capital ratios); and
- Future stress tests, which may impose more severe scenarios, and focus more on adverse sovereign debt and deflation scenarios.

Similarly, although banks have made good progress towards meeting the new LCR and NSFR requirements, with the latest EBA analysis[5] showing that on average European banks exceed 100 percent on both measures, additional demands on at least some banks will arise from:

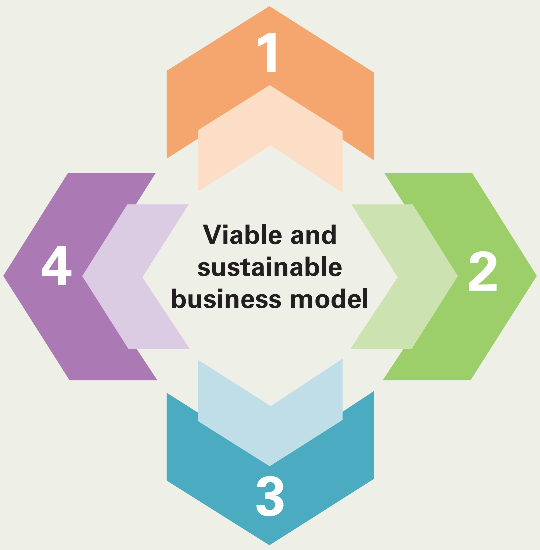
- The average results in the EBA analysis mask wide dispersions across banks, with a substantial proportion of banks not yet meeting one or both of the new ratios;
- The imposition of additional liquidity requirements by supervisors as a result of tougher requirements for SIBs, stress testing and other Pillar 2 considerations, and possibly from macro-prudential considerations;
- The funding implications of minimum requirements for bail-inable long-term debt (MREL and TLAC); and
- The eventual need for some banks to replace their current reliance on ECB operations for a substantial part of their funding.

5 EBA CRD IV – CRR/Basel III Monitoring Exercise, March 2015

## At the centre: Sustainability and viability of banks' business models

**Profitability**

- RoE more than covers cost of equity
- Successful provision of profitable business lines
- Cost control




**Liquidity**

- Meet all regulatory liquidity requirements
- Meet internally assessed liquidity and funding requirements
- Liquidity planning
- Ability to access additional liquidity as and when required

**Capital**

- Meet all regulatory capital and leverage requirements
- Meet internally assessed capital requirements
- Capital planning
- Ability to access fresh equity as and when required

**Resolvability**

- Meet all legislative requirements on structure and resolution
- Credible and effective recovery and other contingency planning
- Facilitate resolution planning by the authorities
- Legal and operational structure, continuity of critical economic functions and of the services that support them
- Sufficient loss absorbing capacity

Source: KPMG International 2015

In addition to regulatory and economic headwinds, **banks also face pressures from the changing expectations and behaviour of their customers, and from increased competition:**

- Large corporates are making increasing use of capital markets to raise funds, rather than borrowing from banks;
- Many SMEs are disillusioned with banks, leading them to seek alternative channels of borrowing, including peer to peer lending;
- Further shifts to alternative channels of intermediation may be encouraged and facilitated through the capital markets union initiative in Europe;

"Banks need to manage proactively their non-performing exposures to remove the drag on earnings from these assets."

- Customers lack trust in banks;
- New and niche banks, and challengers from outside the banking sector, are seeking to exploit profitable opportunities in specific areas of banks' business, such as deposit-taking, lending to individuals and SMEs, and payment systems; and
- Established banks may be particularly vulnerable to alternative propositions based on more trusted brands, on new digital channels, and on smarter and more efficient use of technology and data.

Banks need to align their business and operating models to this new environment.

## Viable and sustainable business model

**A fundamental overhaul of a bank's business model requires:**

- **A clear understanding of performance;**
- **Managing out non-performing exposures;**
- **Capital optimisation;**
- **Re-pricing;**
- **Cost reduction; and**
- **The development of a revised strategy.**

## Performance basics

Banks need to understand the relative and absolute performance of their operating entities and business lines across the four dimensions of a viable and sustainable business model. So they need to understand the return on assets, return on equity, capital and funding requirements, and leverage and resolvability requirements, for each significant operating entity and business line.

Banks can then focus on entity level viability, sustainability and resolvability, and take decisions on the closure or running down of insufficiently profitable businesses.

## Non-performing exposures

Banks need to manage proactively their non-performing exposures to remove the drag on earnings from these assets – by recognising where these non-performing exposures are located across the bank, and taking measures to sell or restructure these exposures, or at least to move them into a non-core entity so that the performance of the remaining core bank can be more easily assessed and monitored.

## Capital optimisation

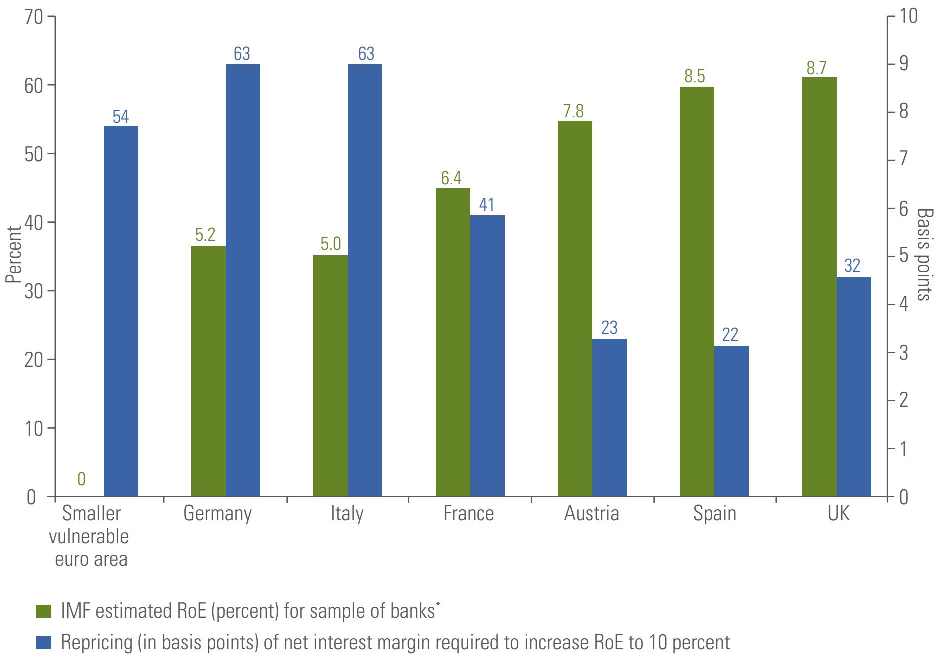
Even with the increasing regulatory constraints on the extent to which banks can drive down calculated capital requirements through the use of internal models, there remains scope for many banks to transfer portfolios from standardised to model-based approaches, and within model-based approaches to make better use of data and model specifications to derive more risk-sensitive capital requirements.

## Re-pricing

Banks need to improve their net interest and operating margins as one element of improving profitability.

Having de-risked their balance sheets by moving into safer and more liquid but low-yielding assets, banks with strong capital and funding positions (the supply side) combined with strong economic growth in the countries in which they operate (the demand side) would be in a position to re-risk their balance sheets by growing their higher margin assets. However, these supply and demand side factors are not yet in place for most European banks, and the prospects for reaching such a position seem bleak.

**Repricing to cover return on equity shortfalls**




*Based on analysts' forecasts for 2015
Source: IMF Global Financial Stability Report, October 2014

> Banks also need to cut costs .... but the rising cost to income ratio for European banks shows that significantly more progress needs to be made.

Moreover, as the IMF point out,[6] the amount of re-pricing necessary to enable some banks – especially in the euro area – to generate sustainable profits may not be feasible. The IMF estimates that banks in some countries would need to increase their margins by more than 50 basis points on average across all their assets in order to generate a 10 percent return on equity in 2015 – and these estimates assume that these banks do not face capital constraints and are able to increase their customer lending.

This amount of re-pricing is unlikely to be achievable. Banks attempting to deliver such an increase would lose business to other, less pressured, banks and to non-banks. The IMF therefore uses this measure not to predict how far margins will actually rise, but as an indicator of how far banks still have to move in their transition to new business models.

## Cost reduction

Banks also need to cut costs. Some progress has been made here since the financial crisis, but the rising cost to income ratio for European banks shows that significantly more progress needs to be made. Banks in the Middle East (where cost to income ratios are generally lower than in Europe) are also focusing increasingly on cost reduction, not least in response to the sharp decline on oil prices.

6 IMF Global Financial Stability Report, October 2014

> "On average, bank salaries have continued to rise more rapidly than in most other sectors of the economy, and have not reflected the declines in bank income and profitability since the financial crisis."

**Five areas provide significant scope for many banks to reduce costs:**

**Salary costs:** On average, bank salaries have continued to rise more rapidly than in most other sectors of the economy, and have not reflected the declines in bank income and profitability since the financial crisis. Banks need to discriminate more in the salaries they pay to their staff, identifying areas where salaries do not need to be out of line with other sectors, and acting accordingly. A weak economic environment and moves towards a smaller and more consolidated banking sector, especially in Europe, should make the necessary adjustment easier to achieve, with less risk of a 'first-mover' disadvantage.

**Staff numbers:** The closure of, or reduction in, some business lines, branch closures, and greater reliance on digital delivery channels for products and services all provide scope for a further reduction in staff numbers. In Italy for example, the number of bank employees has been reduced by 18,000 (5 percent) over the last five years, and 2,800 branches (8 percent) were closed over the same period.

**Simplification:** Some of the cost base of banks reflects the complexity of their products, services, legal and operating structures, operating platforms and systems, and booking models. There is scope to simplify in all these areas, and to drive down costs accordingly.

**Investment in technology:** Combined with less complexity, IT investment is capable of reducing costs over the longer term, while also improving (or at least protecting) income through improved customer service, risk management and cyber security.

**Outsourcing/shared services:** Banks should be able to benefit from centralised and streamlined infrastructure platforms capable of supporting multiple business and customer propositions, on either an internal or outsourced basis.

## Strategy

Banks are pursuing different strategies. There is no unique path to a viable and sustainable future.

**Five approaches can be identified:**

Some banks already have a successful business model which has proved to be robust during the financial crisis, delivering across the dimensions of profitability, capital and liquidity.

A small number of banks have moved decisively to a different and viable business model in response to the financial crisis, not least by moving quickly to identify and develop successful core business activities, shedding activities deemed to be insufficiently profitable, and simplifying and rationalising legal and operational structures.

Some banks are adopting a proactive approach to strategic change, but without a very clear sense of an end point. The jury is still out on whether this will be sufficient to generate a viable and sustainable future.

Many banks have been forced to contract and restructure to survive, but very reactively in response to losses and capital shortfalls. This may have enabled these banks to meet minimum regulatory requirements, but it remains uncertain whether they have a viable and sustainable future in terms of profitability.

Too many banks are hoping that a battered model will somehow pull through in the end, without the need for significant strategic change.

The more successful of these strategies share some common elements:

- **Strategic focus:** taking clear and proactive decisions on which business activities to provide, in which geographies, and for which customers. Some previously multi-activity global banks have narrowed down their regional presence and/or their product and service offerings.
- **Customer focus:** identifying and delivering products and services that customers (retail and wholesale) want and are prepared to pay for (to enable the bank to make an acceptable return), and which the bank is capable of delivering effectively and efficiently. This relates to both the products and risk management services themselves, and the channels through which they are delivered.
- **Product innovation:** meeting changing customer needs through more effective use of data and digital channels and platforms, and differentiating products and services from the competition.

"Some previously multi-activity global banks have narrowed down their regional presence and/or their product and service offerings."

"The IMF and the EBA have highlighted the potential advantages of supervisory intervention to remove non-viable banks from the system."

- **Culture:** shifting from a product push to a product life cycle approach focused on providing customers with seamlessly integrated and clearly value-added products and services, and creating a loyal customer base.
- **Profitability focus:** identifying and concentrating on core activities in both domestic and foreign markets.
- **Distribution focus:** differentiating more rigorously between lending that remains on the bank's own balance sheet, and lending where the bank takes on more of a distribution role (origination and securitisation) in order to free up capital and reduce the amount of stable funding required to support longer-term lending. This is consistent with the long-standing regulatory encouragement of the covered bond market and early steps towards the growth of simple and high quality securitisations.
- **Cost focus:** reducing costs to levels that deliver profitability, and indeed to a point where lower costs can be the basis for competitive pricing in target markets.
- **Funding focus:** attracting sufficient stable deposits to match the size and structure of assets, maintaining a balance between secured and unsecured funding, and retaining flexibility from the pre-positioning of funding as a contingency. Customer service is likely to be key to retaining stable retail deposits at an acceptable cost.

## Consequences of non-viability

Banks that fail in this transition to a viable and sustainable future could potentially remain as low profitability banks, supported by some combination of indifferent shareholders, funding from the ECB and supervisory forbearance.

But in addition to the likelihood of investor intolerance for very low profitability, there are emerging signs of more proactive supervisory intervention. The IMF[7] and the EBA[8] have highlighted the potential advantages of supervisory intervention to remove non-viable banks from the system (or at least to reduce their size), not least to make it easier for the remaining banks to re-price their business on a sustainable basis. The EBA has stated that:

> *"Supervisors will need to assess banks' profit and funding models, risk pricing, business mix, management strength and strategy, and engage with banks' management on appropriate action where sustainability is in question ….. a smooth exit of the weakest and non-profitable banks would contribute to competitive efficiency ….. these exits might have to continue further with a view to eliminating excess capacity in the industry and restore adequate profitability."*[9]

7 IMF Global Financial Stability Report, October 2014
8 EBA Risk Assessment Reports, June and December 2014.
9 EBA Risk Assessment Report, December 2014.

The ECB and the UK PRA have emphasised their intention to focus increasingly on the sustainability through the cycle of banks' business models. And where banks have been subject to formal restructuring plans as a result of receiving government support, the European Commission has required these banks to demonstrate viability in terms of capital, liquidity and profitability.

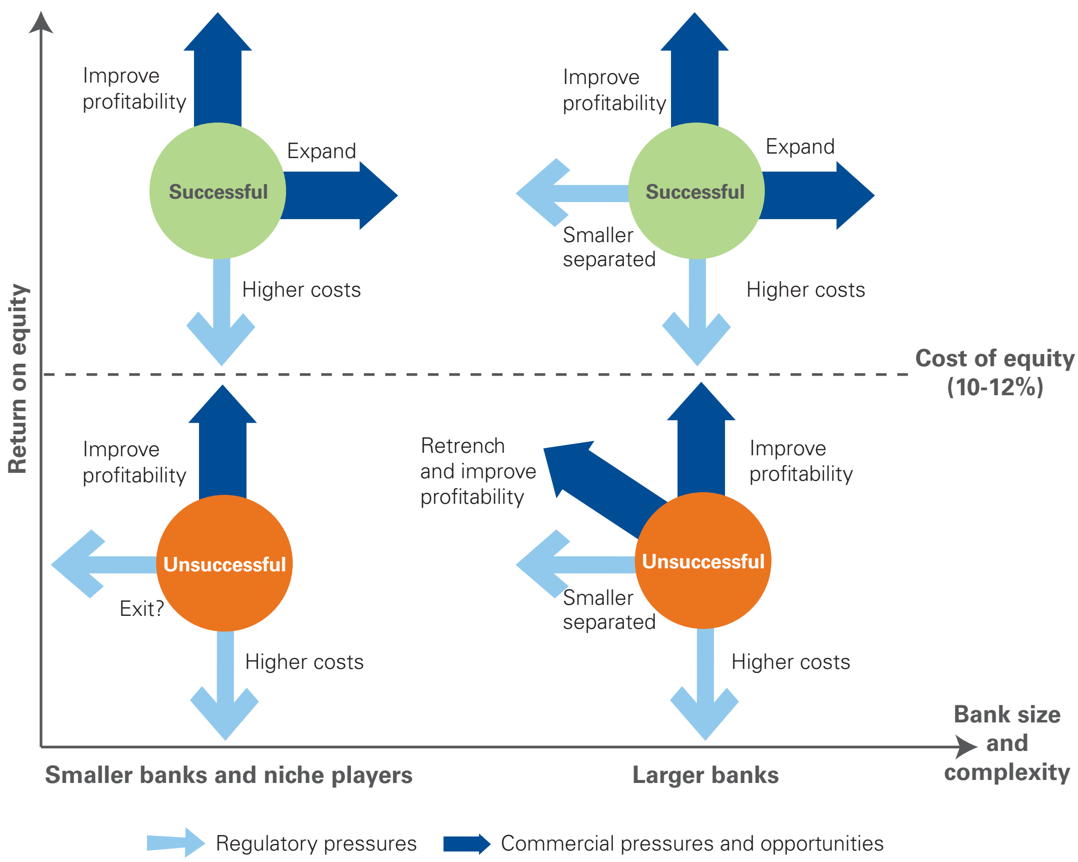
For the moment, however, it remains unclear how proactive supervisors will be in taking forward an exit strategy as recommended by the EBA and the IMF, especially where banks meet regulatory capital and liquidity requirements despite their lack of profitability. Indeed, in some countries, including the UK, the emphasis is more on encouraging new 'challenger' banks to enter the market to promote competition than on engineering the exit of unviable banks.

## Conclusion

Banks face a myriad of commercial and regulatory pressures, as illustrated in the *Pressures on Banks* graphic below. All banks face higher costs from regulatory reforms and commercial pressures to become more profitable. Large banks face various regulatory pressures to become smaller and, in some cases, to restructure. And banks with low returns on equity also face regulatory pressures to contract or even to exit the industry.

> "All banks face higher costs from regulatory reforms and commercial pressures to become more profitable. Large banks face various regulatory pressures to become smaller and, in some cases, to restructure."

### Pressures on banks




Source: KPMG International 2015

# EU negotiations

The Council and European Parliament have been developing their positions on the proposed Regulation. A handover paper[10] from the Italian to the Latvian presidency at the end of 2014 noted that some member states had concerns over:

- **The proposed ban on proprietary trading** – the majority of member states would favour the separation of proprietary trading from non-trading activities rather than a full ban. This could potentially take the form of a three-way split between proprietary trading, other trading and investment banking, and retail deposit-taking.
- **Separation** – member states have pointed out that any framework for separation should not be detrimental to the role played by market making activities in providing liquidity to the markets, or to the universal banking model.
- **Systemic risk** – it is recognised that, even after separation, the trading entity might still be of systemic importance.
- **National discretion** – some member states would prefer the application of 'framed discretion', under which the metrics in the proposed Regulation would not automatically trigger structural separation, but an assessment of a bank's trading activities and of the scope to apply stricter prudential measures (as an alternative to structural separation) to dissuade banks from engaging in excessively risky trading activities.
- **Ownership of the core deposit-taker** – some member states would allow a core deposit-taker to own a trading entity, and to protect the deposit-taker through ring-fencing its exposures to the trading entity.
- **Competencies** – some member states want greater clarity on the respective competences and the cooperation framework applying to supervision, resolution and macro-prudential policy, both nationally and between home and host authorities.
- **Derogation** – several member states have objected to the proposed derogation provision, as it could create a precedent in financial services legislation and would not ensure a level playing field. The Council Legal Service issued an opinion that the January 2014 wording is not compatible with the legal basis of the proposal and the general principles established in the Treaties.

Meanwhile, the December 2014 draft report of the Committee on Economic and Monetary Affairs in the European Parliament proposes amendments to the draft Regulation, although discussions in the Committee have revealed a wide range of views. The draft report – which was by no means universally accepted by the Committee – proposed:

- Excluding some investments in alternative investment funds from the definition of proprietary trading;
- Taking a more risk-based (rather than size-based) approach to the metrics for trading activities;
- Protecting trading activities that are central to raising capital for the economy (including market making, and enabling investors to trade securities);
- Giving greater discretion to national competent authorities to use measures other than structural separation to address excessive risk taking; and
- Recognising the raft of other EU legislation that addresses systemic risk through capital requirements, market infrastructure and resolution.

# Structural separation: costly and unnecessary?

The added value of structural separation may be small, and the benefits may not exceed the costs. Three points are of importance here.

First, the **potential adverse consequences of structural separation** could be large:

- A separate investment bank (trading entity) within a banking group may be subject to a separate (and probably significantly lower) 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 become non-viable as a result. This could reinforce the pressures on EU investment banks to pull out of some markets, and place them at an international competitive disadvantage.
- The structural separation of core deposit-taking and trading activities would be both complicated and costly (with higher costs ultimately borne by the customers of banks). It will require the creation of entities that are legally, economically and operationally separate, and internal control processes to ensure that relevant activities do not 'cross the boundary' between deposit-takers and trading entities.
- Synergies supporting the universal banking model could be undermined through the separation of brands and operating structures, and through a lack of sufficient scale to provide both deposit-taking and trading activities in multiple international jurisdictions. Customers would no longer be transacting with a single entity, and banks would have less flexibility in the provision of products and risk management services to customers.

10 http://data.consilium.europa.eu/doc/document/ST-17137-2014-INIT/en/pdf

- Liquidity in the markets for bonds and securities could be reduced further, having already been adversely affected by higher capital and leverage requirements on traded assets, notwithstanding the exemptions for market-making.
- Multiple local requirements would increase the costs of international banking and would reinforce moves by international banking groups to pull back from some international activities.
- Restrictions on the transferability of capital and liquidity across a banking group would constrain a banking group's recovery options and limit the flexibility of "single point of entry" resolution arrangements.
- More generally, structural separation could result in increased regulatory arbitrage, leakages to the shadow banking sector, unlevel playing fields and reduced competition.

Second, **large-scale investment banking activities will remain systemically important**, even if they are separated from deposit-taking within banking groups. So these activities would still need to be resolved in the event of a banking group becoming non-viable – the authorities will not be able simply to resolve the core deposit-taker and to liquidate the trading entity, because the disorderly failure of the trading entity may have a significant systemic impact on the rest of the financial system and on the wider economy. Large trading books and illiquid positions would need to be transferred to a new owner or wound down over an extended period of time.

Third, the **economic, regulatory and political landscape has moved on** since the initial EU proposals were formulated. Banks have already reduced significantly their trading activities. Other already enacted regulatory reforms, in particular the CRR/CRD4 and the BRRD, largely achieve the objectives of structural separation, as illustrated in the table below. A feasible and credible resolution strategy would mitigate much of risk associated with 'too big to fail' banking groups, while powers are also now available for supervisory and resolution authorities to require structural change in individual banks to remove barriers to recovery and resolution. In addition, some countries have already introduced national legislation that delivers similar outcomes to the proposed EU Regulation.

| Objectives of structural measures for banks (as set out in the proposed EU Regulation) | Related measures with similar objectives |
|---|---|
| **Address unmanaged risks**<br>"Preventing the residual unmanaged risks in the EU banking system from materialising" | Not clear what these residual risks are<br>But covered to some extent by:<br>• Higher capital requirements under Basel 3 and CRR<br>• Capital surcharges on global and other SIBs<br>• Ability of member states to impose additional capital requirements and other measures under CRR and CRD4 to address systemic risks<br>• Central clearing of OTC derivatives under EMIR |
| **Reduce risk from trading activities**<br>"Curtail the artificial expansion of banks' balance sheets, particularly those activities of a purely speculative nature" | Higher capital requirements on trading activities:<br>• Basel 3 and CRR<br>• Basel Committee fundamental review of the trading book<br>• Basel Committee and EBA reviews of the use of internal models to drive down RWAs<br>• Leverage ratio (acts as a constraint on low risk weighted exposures) |
| **Limit activities covered by the public safety net**<br>"Reducing the risk that tax payers have to step in to save failing banks" | • Bail-in and other resolution tools in the Bank Recovery and Resolution Directive (BRRD)<br>• Provision under the BRRD for banks to hold minimum required levels of own funds and eligible (subject to bail-in) liabilities (MREL) on a case by case basis<br>• FSB proposals for minimum levels of total loss absorbing capacity (TLAC)<br>• Use of resolution funds (allowed once 8 percent of a failing bank's liabilities have been bailed-in) |
| **Simplify legal and operational structures, and enhance resolvability**<br>"Reducing the cost and complexity of any resolution when required" | • Powers under the BRRD for resolution authorities to require changes to a bank's legal and operational structures (and a wide range of other available measures) to enable the authorities to develop an effective and credible resolution plan |
| **Limit cultural cross-contamination** | • FSB and Basel Committee principles on risk governance, including risk culture<br>• FSB principles and CRD4 requirements on remuneration |

# Abbreviations

| | |
|---|---|
| AQR | Asset Quality Review |
| AT1 | Additional Tier 1 |
| BRRD | Bank Recovery and Resolution Directive |
| CET1 | Common Equity Tier 1 |
| CRD4 | Fourth Capital Requirements Directive |
| CRR | Capital Requirements Regulation |
| D-SIB | Domestic Systemically Important Bank |
| EBA | European Banking Authority |
| ECB | European Central Bank |
| EMIR | European Market Infrastructure Regulation |
| EU | European Union |
| FSB | Financial Stability Board |
| HQLA | High Quality Liquid Asset |
| IMF | International Monetary Fund |
| IRB | Internal Ratings Based |
| IRRBB | Interest Rate Risk in the Banking Book |
| IT | Information Technology |
| LCR | Liquidity Coverage Ratio |
| MiFIR | Markets in Financial Instruments Regulation |
| MREL | Minimum Requirement for Own Funds and Eligible Liabilities |
| NSFR | Net Stable Funding Ratio |
| OTC | Over The Counter |
| P&L | Profit and Loss |
| PRA | Prudential Regulation Authority |
| RoA | Return on Assets |
| RoE | Return on Equity |
| RRP | Recovery and Resolution Plan |
| RWA | Risk Weighted Asset |
| SIB | Systemically Important Bank |
| SME | Small and Medium-Sized Enterprise |
| TLAC | Total Loss Absorbing Capacity |

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