Navigating the impact of geopolitical change on banking regulation

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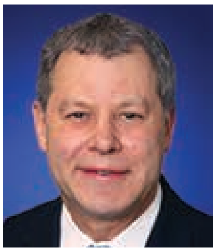

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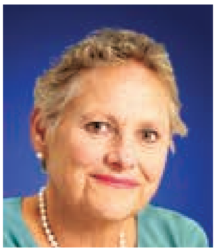

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The election of US President Donald Trump, the UK's vote to leave the EU, the backlash against globalization, the drumbeat of nationalist rhetoric worldwide and growing uncertainty about security in Asia driven by the actions of North Korea — a flurry of geopolitical change and political upheaval is raising fundamental questions about the potential impact on banking industry regulation. With such uncertainty on the global horizon, how can banks prepare for the future?

The new world order that appears to be emerging signals a focus on protectionism and the sovereign rights of individual countries at the expense of global relationships.

The outlook in the US under President Trump is for the repeal of numerous financial industry regulations. This includes provisions enacted within the Dodd-Frank financial reform legislation in response to the 2008 financial crisis during the Obama administration. That sweeping law was designed to decrease risk and enhance stability in the US financial system, but the Trump agenda is to replace parts of Dodd-Frank with legislation offering 'regulatory relief to the banking industry'.

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In the UK, meanwhile, Brexit negotiations are progressing slowly and the prospect of the UK leaving the EU continues to send shockwaves through the financial sector and beyond amid the prospect of new economic rules, relationships and tariffs. Fundamental changes to business models may arise from the post-Brexit location strategies of financial institutions.

The shifting and highly unpredictable environment is creating uncertainty among global banks that are scrambling to identify what the future might hold on the regulatory front. What can banks expect for the time being? We look for three key conditions to prevail amid today's volatile environment:

1. **High expectations on banks.** Banks can be certain that regulators will continue to maintain high expectations and intense scrutiny on the industry. That should not be surprising for a global industry that has paid an estimated USD160 billion in fines since the financial crisis erupted 10 years ago. Scrutiny by regulators has been intense and it will remain exceptionally high as regulators sustain the clear message that misbehavior will not be tolerated and that banks must do their utmost to comply with stringent regulations implemented over the past decade and still being implemented. Regulation can no longer be seen as an issue separate to the business; the key to success here will be effective 'horizon scanning', which aims to identify the impact of new requirements, and consider impending regulatory change as part of strategy development and business planning.

2. **Greater focus on bank conduct and culture.** Beyond high expectations and continued scrutiny, look for a broader focus by regulators as they move beyond enforcement and course-correcting following the conduct issues that have emerged in recent years.

   Regulators will place greater emphasis on governance and compliance, and on the need for banks to maintain highly reliable infrastructure and controls. Regulators will certainly expect financial institutions to be focused on and efficiently managing any new risks and challenges emerging amid rapid technological changes and the emergence of new business models.

   Regulators' focus will turn from the traditional retail banking and insurance products to investments, savings and pensions, driven by concerns about changing demographics and ageing populations in many countries. They will also focus on the fairness of banks' commercial lending practices, in particular in the SME market.

3. **Bank 'safety' is a leading priority.** Thirdly, the industry can expect continued emphasis on the need for financial organizations to keep their capital safe. This will include increased reliance by regulators on 'stress testing' and recovery and resolution planning — creating 'worst-case scenarios' for which banks will be required to provide detailed strategies, responses and solutions. Regulators will expect banks to be able to articulate exactly what will happen if these events occur, linking their responses directly to their operations; theoretical plans will not suffice.

   For example, how would a major financial institution respond in an economic environment marked by a 10 percent jump in unemployment combined with a sudden leap in interest rates and stalled GDP growth? Banks will need to continue to demonstrate in this mock scenario the potential impact on their capital and whether they could continue paying dividends, making acquisitions, sustaining the rate of lending and maintaining services. Stress testing to keep the banking system safe is something the industry can continue to expect the same of in the future.

'Three lines of defense' to navigate today's uncertainty

Over the past decade, risk management has tended to be 'piecemeal'. As they navigate volatile conditions, banks will be well advised to adopt or maintain a holistic, integrated approach to managing risk and uncertainty. This should include ongoing emphasis of the 'three lines of defense framework'.

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This framework is designed to help organizations to:

- clearly identify the roles and responsibilities of their business unit (first line)
- practice ongoing risk management using standard-setters or risk-oversight groups that are responsible for establishing policies and procedures and bringing independent challenge (second line)
- sustain effective risk-management activities via independent assurance providers who report independently to the board or the board's audit committee (third line).

Properly implemented, the three lines of defense will create dialogue and analysis that prevent banks from overlooking emerging risk that could ultimately cause financial disaster, while also prompting banks to effectively manage ongoing risk across the organization.

In addition, businesses should implement dynamic operating models that they review regularly as the business evolves and as emerging technology enables new approaches to risk management.

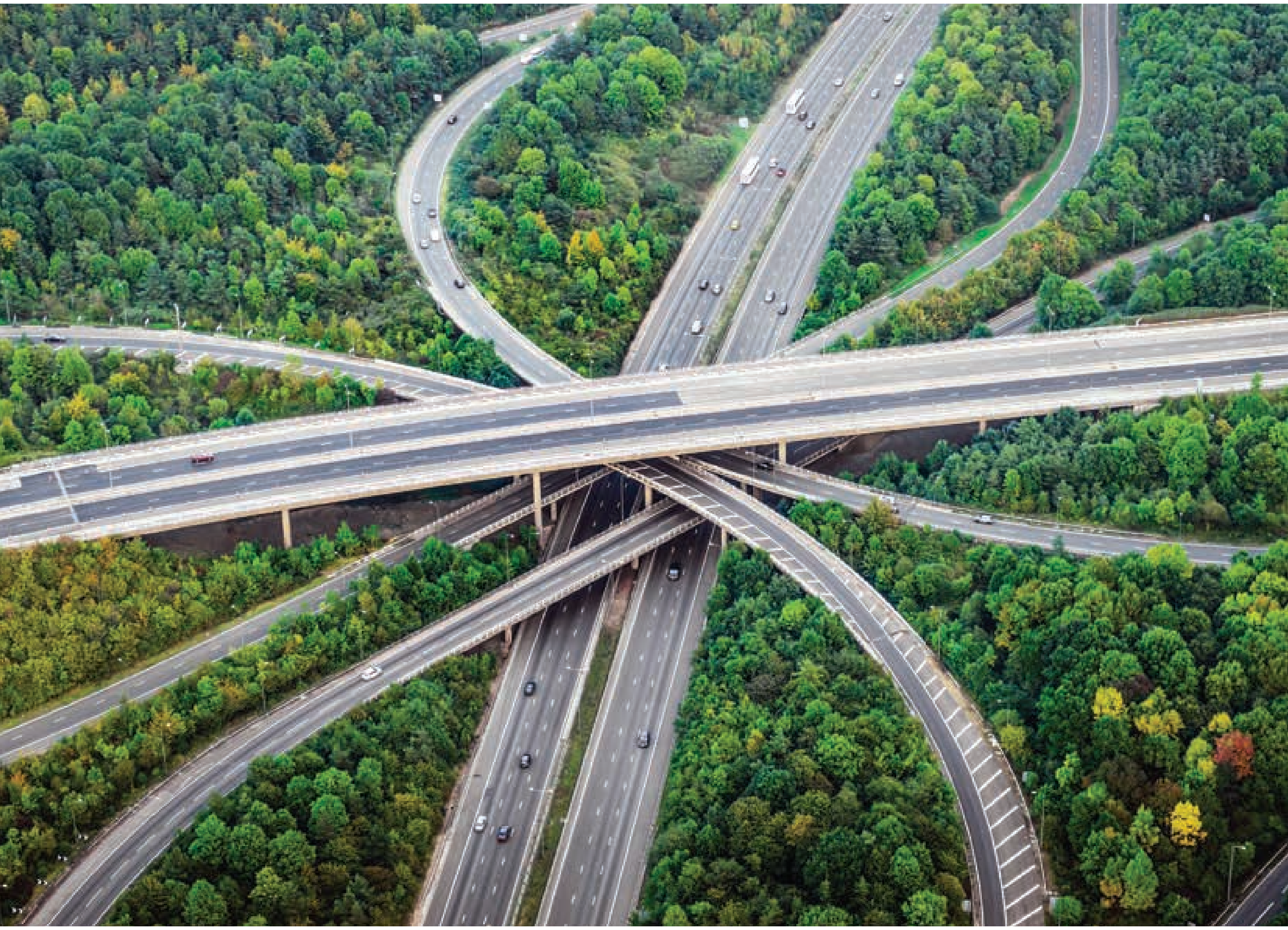
Preparing for potential 'spillover' in Asia

Prevailing conditions and the potential impact of geopolitical issues and regulatory changes affecting the US, UK and indeed Europe will have a spillover effect in Asia given the major presence of Western banks there.

On the question of regulatory change, it remains to be seen what transpires in the US or the UK and how specific changes might exert pressure to respond among regulators in Asia. For the time being at least, pending moves in the US regarding domestic legislation such as Dodd-Frank, for example, would have little impact in countries like China.

Brexit, however, could have a significant impact, in that many banks booking business in the UK will be assessing their base operations and examining whether to relocate bookings or operations out of the UK. Some banks are already looking at repatriating aspects of their Asian bookings back to Asia, specifically choosing Hong Kong and Singapore as booking centers for business currently in Europe. Many will also try to better anticipate future changes via horizon scanning — to try to identify the impact any new requirements coming out of the US and Europe could exert in Asian markets.

On a cautionary note, banks should remain wary of overreacting amid this uncertainty. We have seen many global banks already aiming to minimize risk



and protect capital by maintaining business in their domestic markets while divesting non-core businesses or reducing or limiting overseas activity and expansion. There has been considerable pressure of late, particularly among European banks, to 'look after' their home market first.

But these banks need to tread carefully as they also risk losing future profitability and growth in Asian markets that are profitable and promising steady growth. It's worth noting, that while Western banks continue to recover from reputation damage following the 2008 crisis, major global brands remain well-trusted among the Asian market's customers, investors and even regulators. The caveat to global banks today is to maintain current and future success prospects in Asia, rather than holding back operations and failing to capitalize on current and future growth opportunities in nations such as Hong Kong, Singapore, Thailand, Malaysia and the Philippines.

Looking forward to growth and expansion

While we can anticipate continuing change and uncertainty on the global scene, banks should maintain a strategic, holistic approach that includes a keen focus on meeting high regulatory expectations and scrutiny; enforcing appropriate codes of conduct and sales practices; and ensuring the integrity and safety of their infrastructure and operations. Forward-looking banks will also do well to remain proactive in these times by embracing real growth and expansion opportunities that arise along the way while balancing with the regulatory requirements implemented since the financial crisis to improve the safety and soundness of the banking system. ■

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