Global Regulatory Reform

Adapting to the challenges of multiple regulations: don't let change leave you behind

European capital markets reform
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Current reforms to capital markets regulations have their origin in the Group of Twenty (G20) response to the global financial crisis. The G20 decided that risks, particularly in derivatives markets, needed to be better monitored and controlled. The result was a push to centralize the trading, reporting, clearing and settlement of derivatives and other instruments traded over the counter (OTC).

The European Union’s (EU) response to this reform agenda involves a range of initiatives, of which European Market Infrastructure Regulation (EMIR) and Markets in Financial Instruments Directive II (MiFID II)\(^1\) are the most important. EMIR in particular has much in common with the US Dodd-Frank\(^2\). Common themes include moving trading onto better-regulated, more transparent platforms, increasing the usage and resilience of central counterparties and strengthening investor protection.

Even so, the US and the EU approaches are far from identical. This multilateral, multilayered approach — to say nothing of reforms in other regions — means that large banks operating in Europe face fragmented and overlapping regulatory requirements. As a result, current reforms will have significant implications for the costs, systems, staffing and strategies of the banks and broker-dealers that dominate OTC markets.

To better understand the impact of these changes, we have conducted a survey of leading banks. During the second half of 2013, we interviewed representatives of 24 global and regional banks operating across Europe (referred to as European banks throughout.) The aim was to put capital markets reforms into their broader context and identify the greatest challenges anticipated by the firms.

This paper summarizes the key findings of the survey and interview discussions, which include:

- What are the greatest risks to bank businesses from capital markets reform?
- How much are banks expecting to spend on regulatory change in 2014, and how much was spent in 2013?
- Which components of the regulations are receiving the greatest spending priority, and which are seen as the most challenging to implement?
- What opportunities for innovation and efficiency are expected to flow as a result of capital markets reform?

This paper concludes with EY’s views on the wider strategic impact that regulatory reform is likely to have on European banks’ capital markets businesses, and will help banks gauge their own views against those of their peers.

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1 References to MiFID II also include the regulatory component often referred to as Markets in Financial Instruments Regulation (MiFIR).

2 Dodd-Frank Wall Street Reform and Consumer Protection Act.
Representatives of 24 global and regional banks operating across Europe were interviewed. The aim was to put capital markets reforms into their broader context and identify the greatest challenges expected by firms.
As expected, macroeconomic and political factors, which continue to shape a low growth and low interest rate environment, are a major concern.

But it was striking to find that complexity and the overlapping nature of regulation are seen as the greatest risks. This reflects the distinctive features of this generation of capital markets reforms, in particular:

- Their political origin makes them imprecise and negotiable, creating legal complexity and ambiguity.
- They are highly detailed, affecting many more aspects of banks’ businesses than before.

The capital and liquidity requirements of new regulations are also seen as major risks, with the potential to harm or even destroy the viability of specific business lines. While concerns over fee erosion are muted, there is a widespread expectation that changing regulations and capital requirements will affect revenue structures and business models.

Given these challenges, it is understandable that increased risks of regulatory intervention and reputational damage are cited as leading concerns. However, most firms feel these risks are comparatively well understood at the board level.

On a practical note, legacy technology systems and data infrastructures that are not “future flexible” are expected to increase the cost and duration of change projects. In contrast, flexible systems not only make compliance easier to achieve but can also help firms to introduce new products and services.

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*Percentage of respondents who indicated risk was one of their top 5 priorities

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3. Foreign Account Tax Compliance Act (US)
4. Financial Transaction Tax (EU)
EMIR and the OTC provisions of Dodd-Frank were seen as the leading priorities in 2013, with most banks aligning these two programs wherever possible. Although spending on Dodd-Frank is expected to tail off slightly during 2014, EMIR will remain a major area of effort. As a result, overall OTC spending is predicted to remain steady at 2013’s level.

Meanwhile, MiFID II is moving up the regulatory agenda. Many banks expect it to become increasingly time-consuming during 2014, reflecting the breadth and complexity of its impact. By the end of the year, it is likely to be one of the most pressing items on European banks’ regulatory agendas.

In contrast, tax regulations (such as FATCA and FTT) varied in priority across 2013 and 2014 – either because preparation is well advanced (in the case of FATCA) or because timelines and scope remain uncertain (in the case of FTT directive at the time of writing).

The Central Securities Depositories Regulation (CSDR) is a comparatively minor concern for many respondents. We believe this will climb the agenda during 2014 now that several exchanges and CSDs have announced dates for migration to T+2\(^5\) and the European Central Bank has published timelines for Target 2 Securities implementation.

Many interviewees seem to be focusing on achieving compliance with the new regulations before they turn their attention to identifying possible opportunities. This is entirely understandable, but we believe European firms need to consider both aspects in tandem if they are to optimize their responses to the current reforms.

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\(^5\) T+2 refers to settlement of trades two days post transaction
Spending priorities

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On average, between half and two-thirds of banks’ change budgets are expected to be spent on mandatory projects during both 2013 (57%) and 2014 (54%).

New regulations are identified as the major driver of mandatory spending; however, some banks are also being forced to spend on improving compliance with existing regulations.

Discretionary spend is typically driven by a wide range of factors, of which the most important were discussed and identified as:

- Cost reduction and improved efficiency
- Customer service enhancements
- New market entry
- New product initiatives
- Collateral optimization and collateral transformation services

Banks’ levels of discretionary change spending were higher than we had expected. However, there is clearly some potential overlap between “discretionary” spending on new products and services, and responding to the challenges and opportunities posed by new regulations. Our conversations with interviewees show that discretionary change spending is often allocated to infrastructure enhancements that also play a key role in supporting regulatory change, or reducing regulatory risks.

What approx. % of your change spend is mandatory or discretionary in 2013?

What approx. % of your change spend will be mandatory or discretionary in 2014?

* Eight of the 24 banks surveyed did not disclose their levels of spending

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Major European banks anticipate spending an average US$35m–US$65m per annum on capital markets reform in both 2013 (US$37m–US$66m) and 2014 (US$33m–US$63m).

Budgets are near to US$100m mark for the largest global banking groups. Overall, this represents total spending of US$1b–US$2b over two years by the 16 banks that responded to this question.

Several interviewees hinted that their overall capital markets reform spending is unlikely to decline quickly after 2014. This implies that change budgets will remain at their current levels for several years.

Even so, the focus of spending is constantly shifting. Spending on the structural reforms of Dodd-Frank and EMIR is expected to decline during 2014. In contrast, 2014 spending on MiFID II implementation is expected to increase by several orders of magnitude from 2013’s level.

Many interviewees agreed with our own expectation that MiFID II implementation will be a challenging, drawn out process that may last several years. The major drivers of implementation expense are likely to be:

- MiFID II’s complexity and breadth of scope
- The fact that MiFID II covers a wider range of assets than MiFID I
- MiFID II’s probable impact on transparency, liquidity, flows and fees

Despite these observations, many European banks expect MiFID II to be easier to implement than EMIR. We fear they are underestimating the time and cost involved as some firms have not yet performed a full impact study. The likelihood that MiFID II spending will not reach its peak until 2015–16 may also be a factor.
Key impacts of EMIR

European banks see EMIR as their single-greatest regulatory challenge. Most firms expect to achieve internal compliance with the new regulation, but it is less clear how well prepared their clients will be.

There is uncertainty about whether corporates and second-tier asset managers will update their systems and processes in time to supply banks with the detailed information they need.

Reporting is an area of concern. The precise protocols and requirements around collateral reporting are a specific area of focus, where additional reporting requirements will be introduced during 2014. An additional challenge is that EMIR’s reporting requirements extend to exchange-traded derivatives. This is one example of an area where European banks cannot draw from their experience of implementing Dodd-Frank.

Delegated reporting is particularly topical. From February 2014, reporting requirements apply to both parties in a derivative transaction. Clients can delegate this reporting to their bank or broker-dealer, but many firms are unsure whether their clients will be able to provide them with the documentation they need within the required timeframes. Banks that fail to report accurately on behalf of their clients – who retain ultimate responsibility – risk incurring reputational damage. Obtaining complete classification and documentation data, particularly from clients outside Europe, continues to prove challenging and is likely to come under increased regulatory scrutiny.

Margining is another major concern. EMIR introduces new margining requirements for OTC transactions that are not centrally cleared. But in the absence of a central counterparty, it remains unclear how both parties to a transaction will reconcile the models they use to calculate initial and variation margin. This uncertainty creates additional difficulties for clients, such as asset managers, who wish to avoid holding unnecessary funds in cash.

The new requirements of EMIR are forcing European banks and broker-dealers to make difficult decisions regarding the services they offer their clients. Some services, such as indirect clearing, are generating less enthusiasm than others. But every bank is struggling to strike a balance between providing the best possible range of services and offering services that are loss-making or that involve too much legal or reputational risk.
European banks are less advanced in their planning for MiFID II than EMIR. As a result, there is still no clear consensus regarding the greatest challenges firms will face while implementing the new regime. Greater clarity should evolve during 2014, but the directive’s components will inevitably be interpreted in different ways by national regulators.

While some banks surveyed already appreciate MiFID II’s complexity, others seem to see it as little more than an update to MiFID I. In fact, the new regime is far more demanding, and ranges from market models to investor protection. Where MiFID I focused on the need for greater transparency across order-driven markets, MiFID II extends this approach to quote-driven markets as well, giving it a much broader scope. As regulators intend to use data reported under MiFID II to monitor market activity, it also has significant overlap with the revised MAD II.

The need to divide trading venues into four categories — regulated markets (RM), multi-lateral trading facilities (MTFs), systematic internalizers (SI) and a new category called organized trading facilities (OTFs) — will introduce further complication to front offices. This will dictate which firms can transact with which clients, in which markets, and what their reporting requirements will be. Businesses that rely on algorithmic trading or dark pools of liquidity are likely to be significantly affected. The need to demonstrate best execution for less liquid products is another major challenge.

Client onboarding is one of the most challenging areas under MiFID II and MAD II. Firms need to divide their customers into three categories with greater scrutiny over suitability disclosures and product texts. This will determine which services can be offered and what their reporting requirements will be. Firms are also expected to demonstrate that all the expenses they incur are adding value to end investors.

In short, we fear that many European banks and broker-dealers have yet to fully realize how complex and demanding MiFID II will be to implement. We expect the new regime to have significant effect on European banks’ transaction flows, revenue streams and business models. We also believe that the ongoing reporting effort could be up to twice as demanding as that of MiFID I.
While many European banks recognize that significant opportunities may arise from the current wave of capital markets reforms, most appear to be putting comparatively little effort into capitalizing on them.

Given EMIR is relatively more advanced than MiFID II, the back office was the most common area of innovative focus cited. EMIR is intended to drive a more centralized market infrastructure; therefore, it is no surprise that many banks are looking to develop their collateral management and clearing services. One popular idea is to develop new financing services for clients by combining securities borrowing and lending (SBL) services with collateral optimization and margining services. Other firms plan to offer enhanced cross-product margining, or expanded collateral transformation facilities.

In contrast, front office innovations are receiving less widespread attention, though this may change as firms become more familiar with the impact of MiFID II. MiFID I led to significant market innovations, including off-exchange “dark pools,” and the second iteration is likely to be at least as far-reaching in its impact. We believe that banks offering innovations, such as new trading platforms, new trading venues and portal access for clients, have the potential to attract more order flow than their competitors.

For now, different firms seem to be considering different approaches to innovation in a post-MiFID II world. Some are concentrating on offering a high-quality, tailored client service experience. Others, especially the largest players, are investing in scale platforms to offer the lowest cost services to the largest number of clients.

Overall, we are confident that EMIR and MiFID II will lead to major changes in European capital markets, and to banks’ capital markets businesses. Faced with this prospect, and with ongoing material cost inflation, European firms need to urgently consider their innovative responses. Putting off innovation until full compliance has been achieved is likely to be a risky approach.
Opportunities for synergies

European banks see clear potential benefits from aligning their regulatory change programs. Our findings suggest that at least 20%-30% of future spending on systems and data structures can be reused to establish synergies.

Almost all the banks we spoke to have combined or aligned their European-based EMIR projects with US-driven Dodd-Frank programs. However, most are struggling to identify similar opportunities for alignment given the limited degree of overlap between different regulatory initiatives. Even so, there may be greater potential for cross-regulatory synergies than generally realized.

Where combining whole programs is not possible, European firms are working to align specific work streams. Capital is commonly identified as an area of potential cross-regulatory synergies, given the obvious overlap between OTC programs and Basel III/CRD IV\(^2\). Reporting and client onboarding are two other areas where regulations, such as Dodd-Frank, FATCA, EMIR and MiFID II, share some common elements.

The survey shows that improving regulatory clarity by comparing notes, liaising with regulators and promoting greater transparency is seen as a potentially fruitful area for cross-industry collaboration. Developing industry-wide protocols for collateral, margining, reporting and client data is also identified as a worthwhile area of focus.

The existence of various industry working groups shows that European banks are open to pan-industry cooperation. But tangible evidence of effective collaboration is scarce, and firms remain tentative about developing shared solutions.

This is not just about the complexity of the current wave of regulation – it also reflects the need for banks to rethink what is core to their business propositions and greater perceived risk of legal and reputational liabilities for mistakes or errors made by institutions.

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\(^2\) Capital Requirements Directive III & IV (CRD III 2010/76/EU & CRD IV 2013/36/EU) and Capital Markets Regulation CRR
As expected, European banks see lack of clarity as the greatest obstacle to implementing capital markets reforms. Uncertainty about the timings and details of incoming regulations implies that many banks and brokers are trying to keep pace with a moving target.

The shortage of qualified resources is also seen as a limitation by many. Most of our interviewees raised concerns that multiple change projects — regulatory and otherwise — are drawing on the same staff. In particular, those with a combination of regulatory knowledge, change expertise and a wider understanding of the business processes are much in demand. This holds true across front and back offices, as well as support services, such as IT.

Budget restriction is identified as another major obstacle. Achieving compliance is undoubtedly a key goal for European banks, but group-level cost-cutting initiatives are reducing total change spend. Within change budgets, regulatory projects need to compete with other key strategic priorities, such as innovation, data analytics and expansion. While most firms report strong board support for regulatory change, they also cite cost control as a strategic priority.

Several of the organizations surveyed seem to be taking a silo-based approach to implementing regulatory reforms. In particular, few appear to be looking at IT from a truly enterprise-wide perspective. Given the budgetary and resource limitations identified by the survey, we believe it is more important for European firms to optimize their cross-regulatory synergies.

Looking ahead, we expect implementation challenges relating to MiFID II to have an increasingly high profile. This reflects the fact that many firms have yet to fully assess the breadth and depth of MiFID II’s requirements, or the impact it is likely to have on their business models.
Even the largest European financial institutions remain uncertain regarding the precise impact of capital markets reforms. Many firms have yet to fully realize the implementation challenges involved. This is particularly true for MiFID II, which is far broader in scope than MiFID I.

It is evident to us that the current wave of reforms will lead to significant developments in the transparency, liquidity and structure of European capital markets. Market participants can expect to see changes at every level, including trading, clearing, reporting, settlement and custody.

These changes will have inevitable effects when servicing clients’ demands. As a result, European banks can expect to see material changes in business flows, pricing and profitability in their capital markets businesses.

Firms need to respond to these challenges – and opportunities – on the basis of imperfect information. The current reforms are not only exceptionally complex, but also full of uncertainties, ambiguities and potential contradictions.

It is only natural that many banks’ primary focus is on meeting the requirements of the new regulations. But firms urgently need to look beyond tactical compliance-related changes toward the strategic changes impacting technology, data, processes and controls.

They need to ask themselves more fundamental questions, such as:

- Are we operating in the right markets?
- If so, how should we structure ourselves for optimal effect?
- What products should we be offering?
- Which customers should we be serving?
- Is our business model viable?
- Do we have the right people, systems and processes in place?

What next?

- It may be tempting to put off strategic questions mentioned above until compliance has been achieved, or until greater clarity regarding the new rules has emerged. The delays that are often a feature of European regulations may also encourage some firms to take a “wait and see” approach.

- In our view, this would be a mistake. Individual firms and the wider industry need to take the current reforms, and their likely effects on business models and European capital markets as a whole, very seriously.

- By asking themselves these strategic questions, European banks will help themselves to break down internal silos and achieve greater cross-regulatory synergies. They will also force themselves to think creatively and to start adapting their capital markets businesses to the post-reform world.

- Firms need to seize the opportunities that capital markets reform provides now. Otherwise, within a few years, they will run the risk of finding themselves compliant, but uncompetitive, or worse still, out of business.
Contacts

How EY can help

EY has extensive experience in helping organizations navigate through regulatory initiatives. Our global regulatory reform team is a dedicated, cross-functional team with years of relevant industry experience advising clients in derivatives risk management, regulatory matters and process or systems changes. The team is composed of core members, as well as those drawn from across the broader global regulatory team.

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