MOVING FAST, STAYING SAFE
How risk and regulation must balance

CAPITAL & LIQUIDITY
RECOVERY & RESOLUTION
SECURITIES VALUE CHAIN
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A NEW FINANCIAL LANDSCAPE

Overview

The convergence of regulatory, government and economic forces on the financial sector is unprecedented. If much of the detail has yet to be determined and substantive differences between national authorities still exist, one thing that is certain is that the financial services industry will look very different in a few years’ time. By Geraldine Lambe.

The number of new rules confronting banks will bring about seismic change in the financial services industry. From new capital and liquidity requirements, to resolution and recovery planning, to tighter constraints on business lines and leverage, to changes in market infrastructure and improvements to consumer protection, banks face a regulatory tidal wave.

And they must act while the current is still moving. While the direction already set for the industry was upheld by last year’s G20 summit in Cannes, at a national and regional level, a huge amount has yet to be finalised and implemented.

Neither is it always a smooth process. “Beneath the top level global agreement, we are seeing a growing level of dissonance about making it happen,” says John Liver, head of global regulatory reform, Europe, the Middle East, India and Africa, at Ernst & Young.

Aside from the practical difficulties in implementation, different approaches to the fundamental building blocks for global reforms are proving problematic. For example, there are differences in terms of insolvency regimes, on what businesses banks are allowed to do, as well as whether or not to impose taxes on financial transactions. The potential for arbitrage by the industry and potentially damaging unilateral changes by national regulators is great.

Divergent approaches

Around insolvency regimes, for example, authorities are not only nervous about what they are on the hook for in their own country, but concerned about their ability to control or influence what happens in the other countries in which their banking groups operate and where insolvency regimes differ, so tensions and concerns have emerged. As a result there have been individual moves towards subsidiarisation, which would mean trapped capital and trapped liquidity at a time when both are scarce. Many see this as detrimental to economic growth.

The cumulative effect of all this for the industry is three-fold: there is a short-term existential threat around having enough funding to remain operational; in Europe, there is a six-month threat around getting up to the revised level of capital demanded by the European Banking Authority; and longer term, there is a compliance and business model threat around adapting businesses to the new environment.

“At the moment, there aren’t many answers to any of the three,” says Mr Liver. “Funding isn’t easy to find and what to put in the liquidity buffer is still a moot point; the environment for raising capital is inhospitable to say the least; and redefining the business model to ensure both compliance and profitability is a complex, strategic optimisation exercise that will prove incredibly challenging.”

The Great Deleveraging

What banks can do to reduce funding needs, and meet capital and liquidity requirements, is shrink. And they are doing it at quite a pace. Businesses that consume lots of capital but are relatively low in profits are being shrunk aggressively. Trade finance has seen consolidation of banks in developing countries, and meet capital and liquidity requirements, the great deleveraging.

Deleveraging is not just a European problem. In the US, Bank of America-Merrill Lynch alone has reduced its risk-weighted assets by $117bn since the third quarter of 2010 in a bid to increase its capital ratios, and other banks, including Morgan Stanley, have stated that they are reassessing what business lines they should still be doing.

Moreover, there is significant risk that a retrenchment by European (and other) banks will have a big effect on other regions – most worryingly on their eastern European borders, where banking is highly reliant on western European banking groups – but also in Asia. Data from the Bank for International Settlements shows that continental European banks are responsible for 21% of the $2500bn in loans outstanding, excluding Japan. Neither will Latin America escape unscathed, as Spanish banks such as Santander pull back and sell down assets in order to augment capital ratios.

Whilst some of the assets that are up for sale are being actively bid for by other banks, most notably Japanese and Chinese players, and new players may enter to fill the gap left by exiting banks, some areas of business, such as credit provision for small to medium-sized enterprises, will be hard hit.

Going forward this suggests a very different industry in a few years’ time, with consolidation of banks in developing countries, only a few surviving global institutions, a simplification of bank portfolios, and regulatory arbitrage as banks favour jurisdictions most friendly to talent and capital.

Shadow Banking

More importantly, a shrinking bank model has huge implications – and one which should worry regulators. As banks deleverage and withdraw, many of their activities are moving to the non-bank or so-called shadow banking sector.

A recent report from the Financial Stability Board (FSB) reveals that the assets of non-bank credit intermediaries in Australia, Canada, Japan, South Korea, the UK, the US and the eurozone had risen to $60,000bn by the end of 2010, surpassing the $56,000bn reached before the financial crisis in 2008. The FSB estimates that such shadow banking constitutes an astonishing 25% to 30% of the total financial system and, with regulation on banks still tightening, most expect that this figure will continue to rise.
Regulators may need to reconsider and fine-tune the leverage definitions of banks to incorporate collateral chains due to the sizeable volumes of pledged collateral that churn between banks and non-banks IMF paper

This should concern regulators, says Patricia Jackson, head of prudential regulation and risk at Ernst & Young.

“Shadow banking runs the same kinds of risks, including credit risk transfer and leverage, maturity transformation and liquidity transformation, yet by its nature it is much more opaque and therefore it is hard for regulators to identify and monitor these risks,” says Ms Jackson. “Crucially, much of this activity falls outside the regulatory perimeter but involves credit intermediation chains in which conventional banks are involved. This makes shadow banking a significant factor in overall systemic risk.”

Collateral connection

Against a backdrop of regulatory efforts – from Basel’s liquidity ratios and moving over-the-counter derivatives to central clearing – that are pushing for more collateral, the interplay between banks and shadow banking gets ever more complicated.

In a recent International Monetary Fund working paper, ‘The non-bank nexus and the shadow banking system’, authors Zoltan Pozsar and Manmohan Singh describe how asset managers – including hedge funds, exchange-traded funds, pension funds and insurance firms – have become the key financiers of the banking system and the “ultimate sources of collateral” for the shadow banking system.

Via the process of rehypothecation, long, complicated collateral chains are being created and something the authors call “reverse maturity transformation” is taking place. In this, asset managers (especially real money managers) who traditionally make long-term investments, voluntarily transform their long-term assets into short-term liabilities, largely as a way to boost returns.

As a corollary, since asset managers typically want to reinvest the cash collateral received for such securities lending, there has been an increase in cash reinvested into extremely short duration paper that is as high yielding and as ‘safe’ as possible, such as treasury bills and repos.

The volumes involved are significant. According to the paper, at the end of 2010 there was something like €5,800bn in off-balance sheet items of banks related to these sort of ‘collateral mining’ operations and collateral re-use. And, since it is difficult to track the linkages of this sort of reverse transformation and re-use of collateral, the authors suggest that the process can have serious implications for an understanding of financial institutions’ balance sheets and the measurement of financial and monetary aggregates.

The increased risk of a collateral crunch would lead to much greater funding stresses than might otherwise have been expected – and this has real micro- and macro-prudential implications, say the authors.

“Regulators may need to reconsider and fine-tune the leverage definitions of banks to incorporate collateral chains due to the sizeable volumes of pledged collateral that churn between banks and non-banks,” says the paper. “For example, Lehman, at the eve of its bankruptcy, had $800bn in pledged collateral that could be repledged in Lehman’s name, while its balance sheet size was only about $700bn.”

Economic impact

The convergence of regulatory, government and economic forces on the financial sector is unprecedented, and many argue that policymakers’ belief that the slew of changes will have a negligible effect on the global economy is overly optimistic.

Holding more capital and lower-yielding liquid assets will depress bank returns. Estimates vary, but many argue that returns on equity in investment banking could fall from about 20% in 2010 to about 7%. As a result, firms will charge more to clients and close down capital-intensive businesses; but even with such actions, returns could dip to 12% to 14% and barely cover banks’ cost of capital.

While this may lay bare that much bank activity was made profitable by leveraging up, it will have implications for the global economy as banks constrain the supply of credit or raise prices to bolster returns. According to the Institute of International Finance, the combined impact of new banking regulations may be to cut gross domestic product by 0.7% a year over the next five years and could cost some 7.5 million jobs in the process.
BANKING’S BIG ADJUSTMENT

Capital and liquidity

The combined and cumulative effects of new regulations and a hostile market environment means banks are fighting to build both capital and liquidity. Many questions remain about banks’ ability to do both, and the effects of doing either on economic growth. Geraldine Lambe reports.

IN A QUARTERLY EARNINGS CALL IN OCTOBER, James Gorman, chief executive of Morgan Stanley, told investors and analysts that the investment bank is constantly reassessing “under what conditions we would act to shrink or change businesses” and added that: “We’re not myopically focused on our size.”

The suggestion that the second largest US investment bank is thinking about shrinking provides stark evidence of the market and regulatory realities facing the banking industry. The combined and cumulative effects of Basel III, the EU’s fourth Capital Requirements Directive and new liquidity regimes are having a staggering effect. In the coming months and years the shrinking provides stark evidence of the market and regulatory realities facing the banking industry. The combined and cumulative effects of Basel III, the EU’s fourth Capital Requirements Directive and new liquidity regimes are having a staggering effect. In the coming months and years the shrinking provides stark evidence of the market and regulatory realities facing the banking industry. The combined and cumulative effects of Basel III, the EU’s fourth Capital Requirements Directive and new liquidity regimes are having a staggering effect. 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UTILITY MODEL LIMITATIONS

But at the core of the debate is whether banks can remunerate capital at levels attractive to investors. Clearly, a major premise of incoming regulation is the notion that if banks are made safer, investors will be prepared to accept much lower returns on equity (ROE). In this new world, banks will have a utility-style profile in which earnings are stable rather than stellar; but can a utility model be applied to banking?

Patricia Jackson, head of prudential regulation and risk at Ernst & Young, thinks not. She argues that institutional investors accept utilities’ lower ROEs because they are predictable and stable: their assets are transparent, their charging structure is clear and they have a virtual monopoly, so investors are able to value utilities accordingly.

"Banks do not and cannot fit this profile," says Ms Jackson. "How much risk is there in a monopoly company – can a water company fail? Banking is a wholly different business model and operating environment. It has cyclical where utilities do not; because of unique competitive issues, it has information asymmetries that cannot be entirely eliminated, even with the greater disclosure that new regulations will bring in."

Mr Mumby agrees that it is impossible to compare them because, unlike utilities, banks are both cyclical and geared, so an investor’s risk rises quickly as the macroeconomic environment deteriorates. “To think that banks can deliver the same return as an electricity or water company and that investors will accept it is a bit optimistic. Bank risk is just too great. As we've seen, if you invest in a bank and it goes wrong the dilution is enormous,” says Mr Mumby.

“If banks have twice the capital, it doesn’t mean they are half as risky,” he adds. “Even if banks had twice as much capital as they have currently, an investor will still lose money if Europe blows up; a bank is still geared and not immune from going bust. The problem with banks is not so much the levels of capital, it’s the riskiness of their assets.”

Key to persuading investors that bank equity is safer, is improving the quality of disclosure so that investors can rely on the published capital ratios to judge the relative strength or attractiveness of different banks. Goldman’s Mr Charnley believes that in the long term, industry stress-tests – which apply the same standards across different parts of the system – will be the best way forward.

“If the regulators get that right, and are able to give confidence that the way they stress-test banks and the publication of the results is robust, that’s probably the best way investors can judge the relative health of different banks," he says.

LIQUIDITY REQUIREMENTS

The other pinch point for banks is much more stringent liquidity requirements. The key elements under Basel III are: the liquidity coverage ratio, designed to ensure banks can survive a month of acute liquidity stress; the net stable funding ratio, intended to encourage the funding of illiquid assets by stable deposits; and the principles of sound liquidity risk management and supervision, requiring banks to enhance their internal controls, supervisory reporting and public disclosure of liquidity risks.

The resulting challenges for the industry are three-fold: composition of the liquidity pool, cost and implementation. “It costs a lot and it takes time,” says Ms Jackson. “To have the right information available on a consolidated basis, intraday and every day, requires a huge amount of investment into technology, processes and governance. It is not just a question of having the information; it is also about having people who understand it and will make the right decisions based on it.”

In some ways, the supply constraints – such as the availability of deposits, medium-term funding and high-quality assets – make meeting liquidity requirements a bigger challenge than raising capital. Thus far, a high proportion of the pool has to be in government bonds, but increasingly the industry is calling for a broader range of assets to be eligible.

Deciding what can be used is a thorny issue, says Mr Ervin. “Defining government bonds as risk-free has obviously now been called into question and there aren’t enough to go around anyway, so we will need to broaden what is eligible. Whether that’s expanding the universe through greater use of covered bonds or certain other AAA type assets, subject to some tough tests or a significant haircut, that’s unclear,” he says.

Many bankers say it is worth considering high quality equities. “I was surprised at how liquid high-quality equities remained”
during the crisis – in some respects they ended up being less risky and easier to borrow against than many other assets, even some government bonds,” says Mr Ervin. “If you looked at trading in Greek bonds now versus the S&P 500, it’s no surprise that the latter is a lot more liquid.”

But this is an uncomfortable notion for regulators, who see equities at the opposite end of the risk spectrum from government bonds. Similarly, with securitisation still a dirty word, the potential for this technology to fulfil multiple objectives has been largely ignored so far, says Ms Jackson.

“A very simple, high-quality securitisation vehicle – one with almost no complexity in the vehicle, and complete transparency over the loans and risks in the pools – could provide a useful tool,” she says. “It would provide another high-quality asset to go into the liquidity buffers, at the same time as funding the balance sheet and helping with deleveraging by taking assets off the books.”

PAINFUL PROCESS
There is no getting away from it, however; banks will have to go through the pain of what Ms Jackson calls the “big adjustment”. She divides the journey that banks have to take into two halves. The first is the painful part: returns on equity will have to go down and margins will have to go up; costs – including compensation – will have to go down; leverage will have to go down; business models will have to be reshaped.

“The question banks should be asking themselves is what can we do to reduce the pain of transition?” says Ms Jackson. There are several straightforward steps that banks can take, she adds, some of which will anyway be part of resolution and recovery planning. For example, they can streamline legal entity structures to make regulation, capital, liquidity and tax changes less painful.

Additionally, while banks cannot reduce the conservatism in their capital calculations, they can look at where data is pushing it up. For example, derivatives houses likely have netting agreements waiting to be agreed in the legal department. Until they are finalised, gross exposures go into the capital calculation. Similarly, banks will have missing data in some of the credit risk modelling calculations, which means that they are having to put in added buffers. Improve the data and banks can reduce capital requirements.

Equally, banks should look at areas of the business in which they are holding assets where the risk-weighted assets are very high. In credit card books, for example, there is likely room to close down dormant, unused cards or to cut undrawn lines against which they have to put up capital.

In the second half of the journey to adjustment, Ms Jackson says banks will have to carry out a complex three-way optimisation of the business across capital, liquidity and leverage. “It’s about completely rethinking the business and asking difficult questions about what businesses can be profitable in the new environment.”

Ms Jackson says that this already complex process will be further complicated by the number of moving parts and the competitive landscape. “Part of the strategy will be deleveraging: deciding what businesses they sell or exit, and what they keep. But given that everybody is changing their strategy at the same time, banks must think carefully about the sensitivity of their strategy to that of other banks,” she says.

To make the transition successfully, banks will need to update their finance models, Ms Jackson adds. “Banks have fairly simplistic economic capital and finance models to set their strategy; they’re bolting together multiple spreadsheets that look at bits of the business individually. This is not enough to address the complex three-way optimisation that they need to do. They need a next-generation of tools.”

ECONOMIC IMPACT
Policy-makers have thus far seemed convinced that the cumulative effect of multiple regulatory changes will have a minimal effect on the economy. Others are not so sure. Ms Jackson says regulators need to keep a careful eye on the outcome of their decisions. “The adjustment period is going to be much tougher than the authorities envisage. If it becomes clear that parameters or timelines need to be adjusted, or other measures have to be taken to avoid unintended consequences, then regulators and policy-makers need to be vigilant and be prepared to do that,” she says.

Mr Charnley is optimistic that there is a growing sense that regulators are willing to listen to reasons for bank behaviour that they did not envisage or that might be harmful to the system or to economic recovery. “They’re certainly prepared to listen very constructively if banks can bring concrete examples of stresses in the system. For example, is the interbank market drying up a response to the eurozone crisis or a response to new regulations or a bit of both? My sense is that regulators are interested to understand why that is and what may be done to alleviate that. Because it’s clearly not something that they want to see.”
As regulators insist that banks change their ways and strengthen their defences against another ruinous crisis, some bankers complain that their demands are unnecessarily onerous. There is, however, one particular area where few dispute the pressing need for reform – in risk governance. But willingness to comply does not change the fact that overhauling risk structures and cultures is easier said than done.

In the buoyant lead-up to the crisis, many banks grievously underestimated the levels of risk to which they were exposed. Some failed to aggregate concentrations of subprime mortgage risk across many different business areas and, as the boom progressed, value-at-risk models based on insufficiently long data histories lulled many into a false sense of security. Even Basel II internal ratings-based models proved misleading if they used a point-in-time rather than through-the-cycle methodology. As banks rushed to sell good assets, liquidity problems emerged in unexpected places.

Major Failure
This failure by banks to measure and to understand the true extent of the risks they were facing was pinpointed as a major cause of market turbulence in 2007 and 2008, not least by the President’s Working Group on Financial Regulation and the Senior Supervisors Group (SSG) of major market regulators. Recommendations and statements of best practice were not slow to emerge from various bodies, including global industry association the Institute of International Finance (IIF), as well as the Counterparty Risk Management Group, the Basel Committee on Banking Supervision and the SSG itself.

The IIF articulated a set of principles designed to promote a consistent and effective risk culture, run from the top. Risk management, it said, is the responsibility of senior management, particularly the CEO, and the board has an essential oversight role. Boards should set, and regularly review, goals for risk appetite and strategy, and monitor performance over time. Risk management should be the direct responsibility of a chief risk officer, with enough seniority and independence to do the job properly. It should not be overdependent on particular models or a single methodology, and models should not be a substitute for ‘thinking’. It should avoid the silo approach and aggregate risk across the firm, while making sure governance structures are implemented at an operational level. Finally, banks should stress-test more consistently and comprehensively, taking into account exposures and aggregations that may have been previously overlooked. Stress-testing results should have a meaningful impact on business decisions.

 Banks, particularly those that had been hardest hit, did not need too much urging. Today, a majority of bank boards have realised that they can no longer merely rubber-stamp the risk appetite fed up to them by management but must take control of the process. In an Ernst & Young survey of IIF-inspired changes in risk management practices, published in 2011, 83% of respondent banks reported an increase in risk oversight by the board, 87% of boards were spending more time on risk management and 86% had established a separate board risk committee.

“The idea that bank boards must understand and be involved in setting risk appetite is now fairly well accepted,” says Barbara Ridpath, chief executive of the International Centre for Financial Regulation. “They are all doing it well, but it’s at the front of most of their minds. Permeating it down to the level of operations, to traders and managers, is a different matter, but at senior and strategic levels they get it – and they understand they will be questioned on it by investors.”

The Hard Part
Accepting board responsibility is clearly the easy bit. Developing a risk appetite framework is less so, and banks are at different stages along this particular road. There is an unanimous agreement that one size does not fit all, even if the overriding principles are the same: to establish a sensible framework and get everyone in the organisation to buy in to it.

The frameworks themselves take different forms. National Australia Bank, for example, has formulated a ‘risk appetite statement’ with three elements: a risk ‘budget’, the economic capital limit within which the bank must operate; a risk ‘posture’, a qualitative expression of capacity and willingness to take risk in each line of business, ranging from ‘conservative’ through ‘neutral’ to ‘expansionary’; and risk ‘settings’, that prescribe key operational limits.

Risk appetite is not the same as strategy, but the two are closely linked. Stilpon Nestor, managing director of corporate governance consultants Nestor Advisors, sees setting risk appetite as a top-down cascade which starts with the determination of absolute risk capacity (the limit beyond which the firm’s survival is threatened) and which should be coordinated with the setting of long-term strategic objectives.

Recovery and resolution planning, determining which businesses would be
The idea that bank boards must understand and be involved in setting risk appetite is now fairly well accepted. Barbara Ridpath

Morten Friis, chief risk officer at Royal Bank of Canada (RBC), agrees that loss is a good place to start the discussion, though it is unlikely to feature in the chosen metrics outside of operational risk. Those metrics, he maintains, need to be forward-looking.

“The metrics must speak to future risk,” Mr Friis says, insisting that they should not focus on asset quality. “Levels of impaired loans or provisions for credit losses reflect decisions made one-and-a-half to two years ago. They are less able to speak to the profile of losses in the coming quarter.”

Levels of concentration in the business are a better expression of risk appetite, since all concentrations give rise to a potential for loss, and here stress testing provides a forward-looking view. “The whole area of stress-testing helps you to understand how the business would perform under a range of different stresses, and where concentrations could hurt you,” says Mr Friis. “Then you can make a decision on whether the return is worth the risk you are taking.”

RBC, he notes, runs more than 30 stress scenarios every night so that it can understand the vulnerability of the business and its portfolios to different combinations of stress and tail events. “Your tolerance for stress-related losses needs to be calibrated,” he says.

Too Many Metrics?
Choosing the right metrics can be a challenge, not so much for credit or even (more difficult, given hedging exposures) market risk, but for less quantifiable areas such as operational and reputational risk.

“You don’t want to have too many metrics, but you need ones that you can allocate to business units and make them accountable to,” says Patricia Jackson, head of prudential regulation and risk at Ernst & Young. Banks must bite the bullet, she says, and accept that they are actually thinking about “appetite for loss”. Given their strategy, how much loss are they prepared to absorb?

Too Many Metrics?

The framework needs sufficient clarity to allow it to be fed down the organisation, to where the day-to-day risk management decisions are made. This is the hardest part of all. Execution is a major issue and, for most, a daunting one. While 96% of banks in the Ernst & Young survey said they had increased their focus on risk appetite, only 25% claimed to have linked it to business decisions.

The ultimate destination is a pervasive risk culture in which any significant decision at any level of the bank, from the boardroom down, automatically takes into account the impact on the firm’s risk profile. RBC carries out a periodic portfolio review of its three dozen or so lines of business. That now includes a discipline of measuring each against the bank’s risk profile and appetite, to guide strategic decisions on whether to stay in the business or to get out. “In most institutions, that’s still pie in the sky,” says Mr Nestor. “In the best ones, it’s a work in progress.”

In the worst ones, he says, information on risk is very fragmented and the central risk management function is very weak. “It’s usually a combination of not enough commitment and a persistent legacy in the institution,” says Mr Nestor. “Of course, if you have enough commitment, you change the legacy.”

Acquiring a risk culture is a dynamic rather than a finite task – the board cannot simply decide it is time to get one and then move on, job done. “There is no silver bullet here,” says RBC’s Mr Friis. “This is an important tool, but it’s not static and needs continually to evolve. And within two to five years it should evolve into something that is appropriate to both the institution and the markets.”

How much progress has your institution made towards your ambitions for better articulating and driving business decisions based on risk appetite?

Source: Ernst & Young survey of risk and regulation professionals, Nov 2011
Banks are being asked to calculate now how they might deal with a recovery situation, drawing up a menu of options and addressing each option in turn. But fundamental questions remain. “There are several challenges facing regulators and banks. First and foremost, at what point is a bank deemed to be in recovery? Who decides? What will the trigger be? Banks may well be in denial but if regulators become involved too quickly, they may precipitate the very outcome they were trying to avoid,” says John Liver, head of global regulatory reform, Europe, the Middle East, India and Africa, at Ernst & Young.

Broken resolutions

The outcome everyone is seeking to avoid is the point of resolution, when a bank is no longer independently viable and the regulators take over. At this point, it becomes a public policy issue around who should bear the losses and who should be protected. In 2008, everyone apart from shareholders was bailed out; now the feeling is that a wider range of creditors should share the losses, including bondholders.

In terms of protection, no one disputes that individual deposit-holders should be paid out but there are further questions around small and medium-sized enterprises, for example, as well as mortgage customers and savers. And payment systems need addressing too. If a large clearing bank collapses, systems should be in place to ensure smaller players do not lose out.

On the wholesale side, the situation is even more complicated. If a bank has lots of outstanding derivatives positions, for example, the challenge is to find a way to wind them down in an orderly fashion without triggering a loss of confidence. This means knowing what a bank’s outstanding positions are and in what jurisdiction they are booked: no small task when trades are multi-faceted.
and go across borders and legal entities.

Resolution planning is at an early stage but banks have been asked to amassed certain key pieces of information, such as the range of products they sell, where they sell them and to whom; what their exposures are and where they are located; which IT systems they use; where these sit within the organisation and the link between a bank’s headquarters and its international offshoots.

INFORMATION DRIVE
The purpose behind such questions is speedy resolution. Specifically, regulators are concerned about how to avoid the ‘Lehman’s weekend’ when the bank failed on a Friday and turmoil ensued from the following Monday. Should such a weekend ever recur, policy-makers are determined to be better equipped, and recovery and resolution planning is supposed to allow better decision-making to be made in very little time.

But the provision of information is not a passive exercise. If a bank provides information that shows its current structure would prevent policy-makers from achieving swift resolution, they will request a change of structure now.

Banks need to make sure the information they give recognises the wider agenda. In other words, the authorities do not just want a mass of information, they want to know what impediments may exist that would prevent a bank being rescued in a short space of time. This is what a living will is all about.

In many respects, this is entirely understandable. Governments now know the taxpayer is the banking industry’s ultimate sugar daddy, there to bail the sector out if need be. But, just as banks are unwilling to lend capital without knowing the borrower’s creditworthiness, so governments are reluctant to extend even the possibility of credit without knowing as much as possible about their potential debtors.

INCONSISTENT APPLICATION?
Nonetheless, many banks are concerned about the implications of the recovery and resolution debate. They are worried about regulators interfering prematurely in their businesses, so hastening the move from recovery to resolution. And they are particularly worried about regulators moving at different speeds and with different priorities in the UK, Europe and the US.

“In the UK, the Independent Commission on Banking [ICB] has recommended that large banks ring-fence their retail banking operations but they have until 2019 to do it. Michel Barnier, the EU commissioner for internal markets, has said he is interested in what the ICB is doing but we believe there is almost no chance of Europe following the UK’s lead. And in the US, the political will seems to be blowing against the separation of investment and retail banks. In fact, Republicans are openly talking about repealing Dodd Frank, which was supposed to be the big financial reform act in the US,” says one banker.

Some banks are concerned that different attitudes towards recovery and resolution are already affecting business activity on a regional basis. “European regulators seem much more intrusive and European banks are in contraction mode. US banks are not,” says one.

Barney Reynolds, partner at Shearman Sterling, admits this is an unsettling time for banks. While there is no supranational authority in charge of regulation, he does not necessarily agree with banks’ concerns that some jurisdictions will be harder to do business in than others.

“Of course, there could be differences between the US and Europe and little glitches are opening up but there is broad agreement about recovery and resolution at a high conceptual level. The key issue is local application but overall, I believe harmonisation is less of an issue than many people think,” he says.

QUESTIONs REMAll
The conundrum is far from straightforward. Regulators claim to be keen to work with one another, share information and promote global co-operation. But, their primary role is to protect the local taxpayer. This dichotomy becomes clear when the rescue involves a bankrupt entity with overseas branches or subsidiaries. And divergent insolvency regimes only highlight the tensions.

With this in mind, regulators are keen to ensure that banks operating in their jurisdiction are adequately capitalised at a local level. Currently, many banks operate a centrally capitalised branch system. Now they are being encouraged to set up locally financed subsidiaries rather than branches outside their own jurisdiction. But this, too, has wide-ranging implications, such as ‘trapping’ liquidity in a country that may not need it.

Moreover, it is not an efficient use of capital. “If banks have lots of subsidiaries, this could create pockets of excess capital and this is fundamentally inefficient. At the moment, therefore, it seems as if the new regulations will reduce capital flexibility and potentially liquidity too,” says Jon Peace, banking analyst at Nomura.

Overall, banks and their advisors are pushing hard for a global approach to regulation, particularly around recovery and resolution planning. In the meantime, banks will be required to submit their initial thinking on this issue and the more thought they put into it at this stage, the more fruitful discussions with the regulators are likely to be.

Predicting the pitfalls around their own possible downfall is fraught with challenges for the banking community. But these need to be addressed sooner rather than later.

Mr Liver says many banks are under-estimating the extent of work involved. “These are big complex projects that require a lot of thinking. Uncomfortable questions need to be asked and difficult issues need to be addressed. Fundamentally, banks are being asked to assess their business through a different lens. Ranging from the complexity of their organisation to merger and acquisition activity to outsourcing, there are consequences for every big business decision.”
ADAPTING THE SECURITIES VALUE CHAIN

Regulatory impact

As regulators seek to push more business onto exchanges and into central clearing, and to make derivatives and other markets more transparent and more resilient, the reform of the securities industry is well under way. What will regulations mean for businesses in practice? Frances Maguire reports.

When the Markets in Financial Instruments Directive (MiFID) came into effect on November 1, 2007, its major aim was to increase competition and consumer protection in investment services. The review of MiFID currently under way – part of a continued push for further consumer reform – extends the MiFID framework to equities and all asset classes and into markets in which centralised bid-offer markets and pre- and post-trade transparency have never existed.

At the same time, the European Market Infrastructure Regulation (EMIR) will reshape the over-the-counter (OTC) markets beyond recognition. The ramifications of this will be widespread – not least because the measures will add requirements in terms of initial and variation margining as well as electronic execution, price publication and centralised clearing.

All change

“The whole notion of netting trades and presenting trades to a clearing house is going to mean that the way business is currently conducted will have to change,” says Dr Anthony Kirby, director of regulatory reform for asset management, Europe, the Middle East, India and Africa, at Ernst & Young.

“Currently, brokers put up initial and variation margins on behalf of fund managers but in the new world to come this will be much more explicit,” he adds. “In Europe, non-financial end-user corporates that are currently using OTC derivatives for speculation will face proportionality tests and may be called upon to put up margin in the form of cash collateral or appoint third parties that will offer collateral transformation services at a price.”

While yet to be finalised, both MiFID and EMIR – and other regulations that are also in the pipeline – will have a huge effect on the securities value chain. But because of the scale of the changes, market participants cannot afford to wait for draft legislation to go through the final review and ratification processes before they act.

Mr Kirby estimates that some 70% of the final legislative text is already settled by the time the European Commission issues its first draft. This means that market participants have to seize the opportunity to set out their first steps towards implementation.

Need for urgency

Not all banks have a head start and some of the mid-tier and especially regional players in Europe are indeed waiting for the final rulebook. They should start looking at the collective impacts as early as possible.

There are four fundamental areas which banks must address. The first is the correct specification of the bank’s legal entities. The location of business is driven by a variety of considerations such as local tax and legal issues, as well as broader macro-economic trends and local infrastructure. Given the huge changes that are emerging, the regulatory environment will be a major driver in ensuring legal entities are sited for optimum effect.

The process of on-boarding clients is also under the spotlight. Banks and investment firms need to look very carefully at how their clients are classified. In Europe in particular, regulators are increasingly sensitive to the characteristics of individual products and their suitability for different categories of clients. For example, OTC derivatives are regarded as complex products, which are only suitable for sophisticated investors (under MiFID II, none of the ‘simple’ products listed are derivatives).

Third, market participants need to look at how they can re-engineer the process-

Does the move towards exchange trading and central clearing for over-the-counter derivatives create any opportunity for the industry?

What level of importance does your institution’s top management assign to consumer protection issues?
ing model for securities trades: from the information provided to clients through to settlements, complaints and failures. There are multiple ways that trades can be routed to the appropriate execution venues; this means a lot of choice but also a huge amount of complexity that has to be managed under higher volumes. With incoming regulation, banks need to ensure that these trading routes remain as efficient as possible.

Finally, banks must address increased reporting and disclosure requirements. They must improve the quality of the disclosure and be able to report to regulators and to clients on a far more frequent and consistent basis.

Mr Kirby says: "For this reason, banks are going to need much more standardised, better quality data and they will need to accommodate how each client and regulator wishes to receive this information. There is going to have to be a step-up in the quality and quantity of reporting that is carried out. Good quality data and the ready availability and ‘processability’ of the data will differentiate the winners from the losers."

**EMIR IMPACT**

While the European Commission’s draft of MiFID II is still a work in progress, there is already a basic framework in place for EMIR, says Stephen Wolff, managing director and head of strategic investments at Deutsche Bank.

"A lot of work has been done to prepare both ourselves and our clients for some of the core changes coming with EMIR. Although we don’t know the exact product set or exact client set that will be affected by central clearing, we know that core flows of derivatives products and our financial services clients will be impacted and there is a lot we can do now to build infrastructural capabilities."

Furthermore, this shake-up means that banks are starting to look at opportunities to standardise the synergies between asset classes, transactions and market practice across centrally cleared interest rate swaps, foreign exchange swaps and options. It is clear that banks will need to take intelligent bets about which products are likely to be centrally cleared and which ones will not, in order to streamline their operations.

Deutsche Bank has recently merged its existing over-the-counter and listed derivatives clearing businesses, creating a new group dedicated to providing execution and prime clearing services across all asset classes. Other banks such as JPMorgan and the Royal Bank of Scotland have taken similar actions. This new model is a direct impact of the regulations for mandatory central clearing, as well as the new Tier 1 capital requirements of Basel III. By offering these ‘one-stop shops’ for exchange-traded and OTC products, both cleared and non-cleared, banks are able to consolidate across asset classes and offer cross-margining and risk attribution value added services.

**DISCLOSURE AND TRANSPARENCY**

MiFID II is aimed at further improving transparency, which all markets will benefit from. But Mr Wolff argues that transparency is a means to an end rather than an end in itself, and says there is a clear distinction between the issues around pre-trade transparency and post-trade transparency.

"All markets accept that post-trade transparency needs to be improved, and will be improved, it is just a matter of agreeing how this is calibrated on a market-by-market basis, as each market is different," he says.

However, Mr Wolff adds that the impact of pre-trade transparency on price formation and liquidity, particularly in the bond market under the current draft of MiFID II, is another matter and is still being discussed.

Part of the problem is that applying an infrastructure built for the equities market to the bond markets – and bringing the same level of transparency to pre- and post-trade bond prices in the current economic environment – could severely impact market-makers’ appetite for providing liquidity. "The only outcome there can be from these proposals is that there will be less liquidity," says Mr Wolff, "and this will greatly impact the end-consumer."

On the plus side, most believe there will be more transparency, innovative business models, better counterparty risk management and more choice in the market. But the price for this will be greater pre- and post-trade complexity and an additional processing burden. Just as trading fragmented under MiFID, clearing could fragment once EMIR takes effect.

**LESSONS FROM MARK ONE**

However, there are some quick lessons to be learnt from the implementation of MiFID I which could significantly ease the pain of the transition to MiFID II. A UK-based IT consultancy, BJSS, recently published a white paper based on an analysis of transaction reporting under MiFID I. The paper analyses all the incidences of banks being fined by regulators for non-compliance with MiFID I – such as incorrect market details, inconsistent reference data and business process failings – in order to identify patterns that can be used to improve systems and processes for the implementation of MiFID II.

One of the clearest patterns identified arose from the complexity of merged entities that have not consolidated their infrastructure. In such cases, banks have ended up with a variety of systems carrying out the same operation and have multiple copies of reference data or more than one interface with regulators. "Regardless of what comes out of MiFID II, banks should be consolidating their systems to make compliance easier and reducing this degree of risk," says Paul Everson, a programme manager at BJSS.

The upshot of the growing complexity arising out of regulation in the front office is an increasing appetite, particularly from the buy-side, for the outsourcing of selective front-office components, says Mr Kirby. "If there are going to be a lot more trading and clearing venues, growing cross-asset class trading, and cross-collateralisation, the question is which banks have the scale, capital and agility to offer the next generation of new services to asset managers looking to take fixed costs out of their models," he says.

Accordingly, reporting and data management – relating to order and execution channels, smart order routing, managing client service agreements, treasury management and facilitating transaction cost analysis tools – are all candidates for outsourcing in the years to come.

And this means that the new regulatory environment will bring opportunities as well as challenges.