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Global Regulatory Network Executive Briefing

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A 2015 regulatory challenge for banks

Shaping strategy to satisfy supervisory standards and investor demands

As banks start the new year, they face a formidable challenge: how to design, implement and manage a business model that will satisfy the requirements of supervisors as well as the demands of shareholders and investors.

Although the emphasis and details may vary from one jurisdiction to another, banking supervisors have a clear agenda: to improve banks' condition, improve banks' controls and improve banks' culture.

Market supervisors also have clear objectives: to improve the efficiency and integrity of markets as well as to protect consumers and investors. Shareholders and investors are demanding that banks provide them with returns commensurate with the risk that they are assuming.

Improving banks' condition has effectively been "Job One" for regulators and supervisors since the crisis. Increases in capital requirements and the introduction of liquidity requirements have made banks more resilient, so they are less likely to fail. Resolution reform is on the way to making banks "safe to fail" so that the system as a whole is more resilient. The net result is more capital relative to assets, and less leverage.

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All else being equal, that spells lower returns on equity, making it less likely that ROE will exceed banks' cost of equity capital.

These trends will continue in 2015. With respect to ***capital***, banks should expect:

- Stress tests to become even tougher. Before supervisors will allow a bank to pay the dividends or make the distributions that shareholders demand, the bank will have to pass one or more stress tests. In quantitative terms, the bank will have to demonstrate that it could still meet minimum requirements after absorbing the additional losses that stress could cause. That effectively amounts to a supervisory standard for excess Common Equity Tier 1 (CET1) capital. But getting the capital number right will not necessarily result in a passing grade. The bank will also have to demonstrate that its controls and risk governance are in order.
- Further tightening of minimum CET1 capital requirements via increasing standardization of risk-weights, limits on the use of internal models and the implementation of leverage ratios.
- Introduction of a requirement — as part of resolution reform — to maintain a minimum amount of reserve capital, that can be converted into CET1 capital when the bank reaches the point of non-viability.

With respect to ***liquidity,*** banks should expect supervisors to:

- Implement the liquidity coverage ratio and finalize the net stable funding ratio.
- Increase scrutiny of liquidity risk — in particular, risks related to re-hypothecation, collateralized funding and securitization.
- Increase emphasis on the importance of banks' securing private sources of liquidity rather than relying on central bank financing. This may lead regulators to facilitate simple securitizations.
- Increase demands for timely reporting of liquidity positions, including unencumbered assets. This in turn may give rise to a discussion on limits to encumbrance.

With respect to ***resolution***, banks should expect regulators and supervisors to step up efforts to assure that banks become resolvable so that a bank can fail without cost to taxpayers and without severe disruption to financial markets or the economy at large. In particular, authorities are likely to:

- Require banks to remove barriers to resolution. The Financial Stability Board has outlined the key steps remaining to assure that banks can become resolvable. Bail-in holds the key, and the recent Total Loss-Absorbing Capacity (TLAC) proposal aims to assure that banks have enough reserve capital available for bail-in at the point of non-viability, so that deposits and other customer obligations, such as derivatives, can continue to perform without interruption. Banks should expect some form of TLAC to be adopted in 2015 for implementation over the next three to five years.

  Supervisors are also likely to demand that banks make further progress on assuring that the recapitalized bank can continue to perform critical economic functions. That will require resolution plans to outline how the bank-in-resolution could obtain adequate liquidity, retain access to financial market infrastructures and maintain the ability to source critical technology and services.

- Take measures to "simplify" banks' structure. Practically every major jurisdiction has initiated legislation and/or regulation to force banks to restructure themselves along geographic and/or business lines. There is an increasing trend — partly driven by efforts to make banks (or at least some portion of banks) resolvable — toward forcing banks to operate via subsidiaries rather than branches, and toward separating trading activities from lending/deposit-taking.

As banks improve their condition, authorities will place increasing emphasis on ***improving banks' controls***. The incidence of control failures and conduct violations appears to be increasing, leading some officials to infer that the fault may lie with the banks themselves, as well as with individual bankers. Regulators and supervisors are determined to arrest and reverse the downward spiral in banks' behavior through enhancing enforcement and improving culture.

Punishment for control violations will continue to increase. Fines are already up substantially, and authorities are increasingly subjecting banks to criminal charges as well as threatening to restrict activities or even revoke licenses. In addition, certain jurisdictions (notably the UK) are making senior managers accountable as individuals if the bank fails or if the bank fails to comply with regulatory standards. Indeed, in some jurisdictions (again, notably the UK), senior managers will be presumed to be responsible for a bank's failure to comply with regulation unless they can show that the bank was taking all reasonable steps to prevent such a breach. Together, these measures will increase the probability that the authorities will catch and convict those who violate the rules as well as increase the punishment that the convicted receive. That will raise the cost that banks can expect to incur from having poor controls.

Accordingly, in 2015, banks should look to strengthen controls. The emphasis in compliance needs to shift toward preventing breaches from occurring. In general, banks should be testing operating procedures "back to front" to ensure that they work as they should. Specifically, banks should be taking steps to assure that they:

- Treat customers fairly. Failure to do so has cost banks dearly. Fines and settlements relating to abuses in mortgage lending and payment protection insurance exceed US$100 billion. To avoid such costs in the future, banks should take steps such as scoring products for conduct risk, as well as designing and delivering products from the customer's perspective.
- Observe proper standards of market conduct. Not all bankers have done so at all times. Individual bankers have manipulated benchmarks (LIBOR, FX), engaged in unauthorized trading and traded on inside information. Banks need to stamp out such practices.
- Can continue in operation at all times. Specifically, banks must protect the integrity of their own systems, not only from hackers who might be looking to steal clients' data, money or assets, but also from cyber-attacks designed to destroy, disrupt or distort the bank's systems and/or corrupt the bank's data.
- Prevent criminals and terrorists from using the bank and from gaining access to the financial system. Banks need to improve their adherence to anti-money laundering (AML) and "know your customer" (KYC) rules, as well as to comply with the extension of KYC into KYCC (know your customer's customer).
- Implement official sanctions against specific entities and/or jurisdictions. Sanctions are increasing in number, complexity and severity (the sanctions on Russia are a case in point).

- Improve data quality. Dependable, accurate and timely data is critical to achieving the regulatory and supervisory agenda outlined above. Unfortunately, the quality of banks' data is often poor. Banks need to make their data more complete, more accurate and more easily accessible. They will also need to be able to report and manage the firm on a legal-entity basis as well as on a group-wide and line-of-business basis.

Increasingly, supervisors are coming to the conclusion that culture ultimately determines whether the bank exercises effective controls and remains in good condition. So in 2015 they will be looking for banks to ***improve their culture***. That is how banks can restore their reputation and regain credibility and, ultimately, trust from their clients. Specifically, supervisors will be looking for banks to:

- Improve risk governance. As a first step, senior management has to set the tone from the top, namely that right behavior is the norm. But this is not enough. The bank also has to reinvigorate the three lines of defense.[1] And above all, the bank has to assure that line management takes responsibility for risk, including non-financial risks such as conduct risk and operational risk.

  The "tune from the top" is just as important as the "tone from the top." Ultimately, the firm's risk appetite framework sets the tune. The right culture results from pushing a sound risk appetite framework down into the organization so that the line business managers make strategic and transactional decisions in accordance with the overall framework.

- Use compensation to reinforce culture. Incentives matter and they will have to be aligned to reinforce the steps that banks take to improve culture.

Finally, regulators and supervisors are looking to ***bolster capital markets*** as a source of financing growth and development while assuring that capital markets enhance or, at least, do not threaten financial stability. Specifically, market authorities in 2015 will aim to:

- Make the derivatives market more robust. Mandatory clearing is the principal measure. This in turn raises the importance of making central counterparties (CCPs) resolvable — regulators are already demanding recovery and resolution plans from CCPs.

  They are also requiring banks to demonstrate that they could retain access to CCPs (and other financial market infrastructures) during the resolution process.

- Control securities funding. Although capital markets finance growth and development, they are also a potential source of financial instability, particularly where the investor finances its securities position through short-term funding. Such arrangements are doubly exposed to variance in securities prices: to falls in the price of the assets the investor owns and to falls in the price of assets the investor pledges to the lender as security.

  Supervisors are concerned that the failure of an investor could touch off a fire sale of the collateral it had pledged to lenders. That could force write-downs at other firms, possibly causing additional firms to fail. To prevent this, regulators are considering forcing lenders to impose minimum haircuts on the collateral they take in connection with securities financing.

[1] The three lines of defense are (1) business line management; (2) risk management and compliance; and (3) internal audit.

- Create capital markets union (in EU). As one of its key initiatives, the new European Commission is looking to augment capital markets as a source of finance and to reduce dependence on bank lending. Various measures are under consideration, including the introduction of a simple securitization regime.

Taken together, these banking and market initiatives constitute a massive supervisory agenda, and supervisors, as well as rating agencies and investors, will be asking the bank to demonstrate that it has a business model that will prove to be sustainable, i.e., one that will consistently earn its cost of capital.

That will require banks to rethink and reshape strategy. First, banks need to concentrate on customer and market segments where they have critical mass. That may spell getting out of businesses where the bank has little hope of becoming a leader, especially if the business is losing money and/or absorbing disproportionate amounts of capital and liquidity. In other words, banks have to recognize that many loss leaders simply lead to nothing but loss.

Second, banks need to improve asset efficiency. Are the assets on the bank's balance sheet simply an investment or do they also promote the bank's ability to do business with clients? Greater focus on the latter, much the way retailers track turnover to inventory ratios, would help banks economize on the use of capital and enhance ROE.

Third, banks need to streamline costs. Here, meeting the supervisory agenda should help banks meet investor expectations as well. Strengthening governance and controls should reduce the frequency and severity of compliance breaches. That in turn will mean fewer fines, lower fines, fewer restrictions on activities and more time for management to focus on building the business. What initially makes it to the bottom line will be more likely to stay there. That should spell higher profits and lower risk — something that will please investors as well as supervisors.

Enhancing data quality may also represent an opportunity for banks to tackle long-standing shortcomings in management and technology. This will not only reduce the considerable cost banks currently incur in collecting and reconciling data, but also improve the basis for risk management.

Finally, the supervisory focus on compensation may give boards the air cover they need to make compensation regimes more investor-friendly, so the bonus would be accrued if and only if equity had earned its cost of capital.

In sum, the challenge is indeed formidable, but banks can rise to meet it, not least because much of what supervisors are demanding is good business as well as good policy.

EY Global Regulatory Network Executive Team

Global

Dr. Tom Huertas is a former member of the Financial Services Authority's Executive Committee. He also served as alternate chair of the European Banking Authority, as a member of the Basel Committee on Banking Supervision and as a member of the Resolution Steering Committee at the Financial Stability Board.

Americas

Ted Price was Deputy Superintendent and a member of the Executive Committee at the Office of the Superintendent of Financial Institutions, Canada, serving on the Senior Supervisors' Group and the Financial Stability Board Supervisory Intensity and Effectiveness Working Group. Ted previously held senior roles at a global investment bank.

Marc Saidenberg was a senior vice president and director of supervisory policy at the Federal Reserve Bank of New York, representing the bank on the Basel Committee, and served as co-chair of the committee's Working Group on Liquidity. He was actively involved in the development of the Basel III capital and liquidity standards, supervisory expectations for capital planning, liquidity risk management and recovery and resolution plans.

Don Vangel, Regulatory Advisor to the Office of the Chairman, joined EY after a 17-year career at the Federal Reserve Bank of New York, where he ultimately served as a senior vice president for bank supervision.

Asia-Pacific

Keith Pogson has more than 20 years of experience advising governments and regulators across Asia-Pacific on banking reform. His expertise includes acquisitions, market entry strategy and due diligence across banking, asset management and securities. He is the Immediate Past President of the Hong Kong Institute of Certified Practising Accountants.

Philip Rodd has more than 23 years of experience in accounting and risk management, including 13 years in the Asia-Pacific region. He assists clients in assessing the impact of regulatory change, implementing compliance initiatives and responding to regulatory findings.

David Scott has spent 14 years working with a number of large global institutions, most recently on the implementation of the global financial regulatory reform agenda. He is involved in addressing emerging regulatory and legislative initiatives and engaging in dialogue with regulators and supervisors on emerging issues.

Judy Vas spent 16 years at Goldman Sachs as a managing director, Head of Regulatory Affairs and Head of Compliance for Asia (excluding Japan). Prior to this, she spent seven years in a senior role at the Securities and Futures Commission in Hong Kong. She sits on the Hong Kong Takeovers Panel, Takeovers Appeals Committee and the Hong Kong Securities & Investment Institute Examination Committee.

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Marie-Hélène Fortesa has extensive regulatory experience, including leadership roles at the Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority), Association Française des Banques (French Banking Association), French National Institute for Statistics and Economic Studies and senior roles at a leading investment bank.

Patricia Jackson was the Head of the Financial Industry and Regulation Division of the Bank of England from 1995 to 2003. From 1997 to 2004, she was also a member of the Basel Committee, where she led the development of Basel II and chaired the Global Quantitative Impact Studies committee and the Basel II calibration subgroup.

Dr. Colin Lawrence was Director of Risk Specialists at the Financial Services Authority (FSA), where he was one of the senior executives responsible for running the stress tests and recapitalization of the UK banks. He was a member of the senior management and transition committee in the formation of the Prudential Regulatory Authority and became Senior Risk Strategist to the Deputy Governor, Bank of England. Prior to joining FSA, he held senior executive positions at major universal banks in Europe and the US.

John Liver has held regulatory roles with leading investment banks, the UK Financial Services Authority and its predecessors. His roles include leading the thematic supervision in the Investment Firms Division; leading the Personal Investment Authority Supervision, where he oversaw the sales regulation of the life and pensions industry; and management roles in the Investment Management Regulatory Organization's Enforcement and Supervision Departments.

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Hidekatsu Koishihara is a former chief inspector and inspection administrator for the Japan Financial Services Agency. He also worked at the Ministry of Finance (MOF) of Japan, Japan's former financial regulator, serving as the financial inspector at the Bank Bureau of MOF and Financial Inspection Division, and Minister's Secretariat of MOF.

About the EY Global Regulatory Network
EY's Global Regulatory Network helps our clients find solutions to their regulatory challenges, providing extensive experience, leadership and strategic insights on financial regulation. Led by Dr. Tom Huertas, former Alternate Chair of the European Banking Authority, the network comprises more than 100 former regulators throughout the Americas, Asia and Europe, many with senior regulatory experience, including membership in the Basel Committee, the Financial Stability Board, the European Banking Authority, the Federal Reserve Bank of New York and the Japanese Financial Services Agency. The network enables our clients to understand and adapt to the impact of the changing regulatory landscape, advising on such topics as:

- Capital and liquidity
- Recovery and resolution
- Governance
- Risk culture and controls
- Structure
- Conduct

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