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SPECIAL REPORT

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2 BANKS TRY TO STAY AHEAD OF REGULATORY TIDE

Senior executives are changing the way their organisations work in an effort to move from merely complying with new regulations to defining how the bank of the future will look.

5 FIXING THE RESOLUTION PROBLEM

European regulators have been trying to create resolution and recovery frameworks that will enable them to wind down failed banks without using taxpayers' money. So far, they have not succeeded. But few bankers are quibbling with the progress made.

7 BIG DATA HELPS TACKLE BIG REGULATION

Regulatory demand for greater insight into banks has pushed financial institutions to seek out scalable and low-cost data processing.

9 BASEL: GOING FOURTH?

Basel III is upon us. Although banks appear to be coping well with the capital-related elements of the regulations, they are having to make fundamental changes to the way they do business – and a 'Basel IV' looms on the horizon.

11 CONDUCT, REPUTATION AND CONTROL

Conduct risk and reputational risk are receiving more attention from banks than ever before as they strive to gain better control over their activities.



THERE'S A LOT OF DETAIL TO BE WORKED THROUGH BEFORE WE CAN SAY THAT WE'VE GOT CLOSE TO SOLVING THE ISSUE OF TOO BIG TO FAIL

John Liver, page 5 ●●

The Banker

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BANKS TRY TO STAY AHEAD OF REGULATORY TIDE

Introduction

Senior executives are changing the way their organisations work in an effort to move from merely complying with new regulations to defining how the bank of the future will look, says Philip Alexander.

IN 2013, MANY OF THE REGULATORY INITIATIVES launched since the financial crisis were coming to fruition. In Europe, the Capital Requirements Directive was finalised alongside the Bank Resolution and Recovery Directive and the launch of a single supervisor for the 17 eurozone nations that is due to carry out an asset quality review and stress test in 2014. The UK introduced legislation to enforce the Independent Commission on Banking's recommendations of ringfencing retail banking. In the US, rules on the liquidity coverage ratio, resolution and liquidation, and the separation of proprietary trading – the Voleker rule – were finalised, and a fresh round of stress-testing launched.

In surveys among banking executives carried out at a series of round tables organised by *The Banker* and EY during the final quarter of 2013, 43% of respondents in Europe, the Middle East, India and Africa and 75% of US respondents said they expected a reduction in business lines or markets by 2016 owing to capital or liquidity constraints. But then, 23% of Europeans and 17% of Americans predicted an increase in appetite for new products and markets. It is easy for senior managers to be overwhelmed by the rising tide of regulation, but clearly vital that they do not lose sight of those opportunities for growth. As post-crisis regulatory initiatives reach final rule-making, banks have a chance to try to move beyond reactive decision-making, and begin planning strategically.

“What we are seeing is that in the planning round for 2014, there is a much bigger focus on how banks frame their plans and budgets so that, as well as addressing regulation, they also position themselves to be the bank of the future. They are asking not just what must we do, but what should we do to direct the strategic future of the bank rather than just implementing the next compliance project,” says Dai Bedford, a partner in the financial services team at EY.



SINCE THE START OF [2013], WE ARE BEGINNING TO SEE MORE STRATEGIC DISPOSALS AS BANKS HAVE STABILISED AND ARE MAKING DECISIONS ABOUT THEIR FUTURE CORE BUSINESS

Peter Meijer ●●

KEEPING CLIENT FOCUS

Edward Thurman is the head of financial institutions at Lloyds Banking Group, and a member of the team that led the bank's strategic review that started in 2011 and returned it to profit in 2013. He is keen to avoid being too dramatic about the impact of regulation, arguing that banks will find ways to adapt to measures including structural challenges such as ringfencing, while still serving clients with the appropriate product set.

“The changing regulatory environment is an important factor in the way in which we will develop our business, but it will not be the single defining factor. We have to stay focused on client needs and avoid being overly distracted by theoretical outcomes,” says Mr Thurman.

If the response is right, banks can use the process of complying with new regulations to inform strategy and steer it in the direction of securing sustainable returns for shareholders. “The more forward-looking banks have realised that many of the requirements created by the swing toward more forward-looking supervision based around stress-testing are also good business practices, including much tighter management of risk and much greater capital discipline, which will ultimately lead to more efficient banking,” says Thomas Huertas, a partner in financial services risk management at EY and former member of the executive committee at the UK Financial Services Authority.

However, Mr Huertas adds that the overall effect is to reduce the risk appetite of banking groups, which will want to retain investment-grade ratings even at the bottom of the cycle. Banks will be able to draw down their counter-cyclical buffers, but will want to determine their asset size strategically at all times. “If you draw the analogy with a retail store, their inventory is there to promote turnover and they always monitor

closely what is the level of that inventory. More of that thinking will have to come into banking so that a lower level of capital is needed to support the inventory," he says.

BALANCE SHEET CHALLENGE

The leverage ratio intensifies that pressure to hold down balance sheet size. In the EY survey, it is the stand-out factor that respondents believe is likely to change their business model (see chart). Independent investment bank Moelis has advised a number of banks such as France's Natixis on winding down books of complex derivatives including credit correlation trades. Peter Meijer, a managing director in the European risk advisory team at Moelis, says 2013 has marked a step-change in the type of asset disposals undertaken by banks.

"Before [2013], the financial crisis was often the driver and banks were disposing of illiquid portfolios to avoid the consequences of further bouts of market instability. Since the start of [2013], we are beginning to see more strategic disposals as banks have stabilised and are making decisions about their future core business," says Mr Meijer.

Basel III is not the only source of pressure for higher capital ratios and lower risk appetite. Pre-crisis, investors wanted to see bank capital highly leveraged. These days shareholders prefer to see their investment strongly capitalised to avoid bail-in and dilution risks, says Patrick Butler, chief executive of contracts-for-difference advisory broker Prime Markets and a former executive board member for treasury and capital markets at Raiffeisen Bank International.

Previously, business lines might be kept as part of the core even if they did not meet the hurdle for return rates but banks need to become more ruthless about applying the test of whether laggard activities can be part of a valid long-term business model.

"There were a lot of banks entering what they perceived as businesses that could generate fees without consuming capital, especially [mergers and acquisitions] advisory. But with competitors crowding into these activities and the European economy static, the reality is that these units often generate negative cash flow, even if they do not require significant capital," says Mr Butler.

GREATER SPECIALISATION

There are also viable businesses that banks are departing because capital requirements are high or evolving. Macquarie, Crédit Agricole and Royal Bank of Scotland have all sold equity derivative and structured product businesses over the past 12 to 18 months,

often including client-servicing platforms. These are viable businesses that attracted an enthusiastic buyer – France's BNP Paribas in all three cases.

"Even with good businesses, regulation can begin to bite, whether it is the leverage ratio or the liquidity coverage ratio. There is a cumulative build-up of costs that is undesirable if the unit does not fit into the bank's long-term plans," says Mr Meijer.

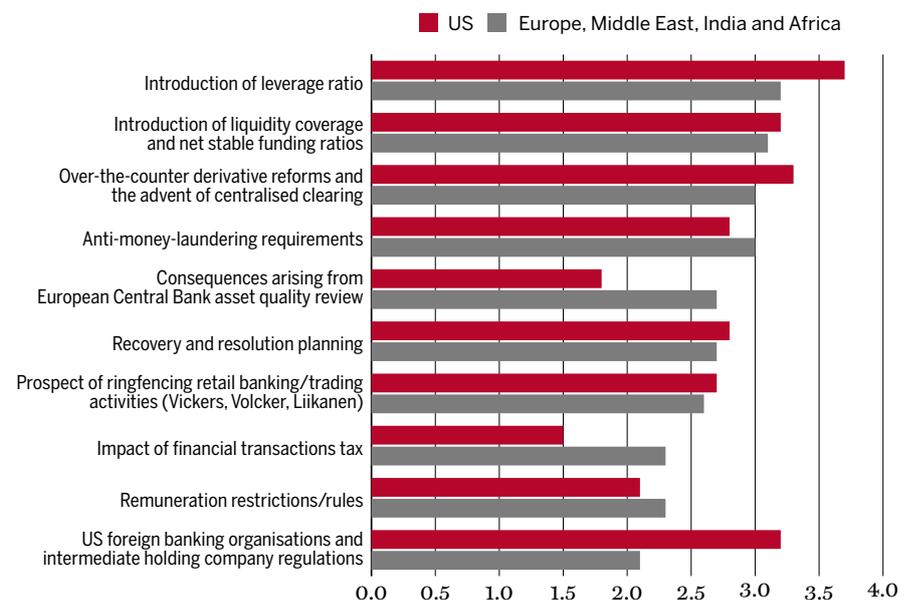
For the strategic buyer BNP Paribas, by contrast, equity derivatives are very much a part of its core and the French bank has the chance to further entrench its market-leading position. Mr Huertas anticipates more specialised and differentiated business models emerging, as banks will exit certain types of business due to regulatory constraints unless they are a market leader in that field.

Even in relationship-driven corporate banking, the landscape is changing. Challenger banks are pushing into areas that the largest players find too heavy for the balance sheet and cost base. For instance, small business leasing and receivables finance specialists Close Brothers and Aldemore in the UK are making headway. Mr Thurman at Lloyds does not see challenger banks as a threat to the large universal banks. Instead, new players are potential clients for the services they do not operate in-house.

"We can mobilise capital for the real >>

Which of the following external issues are the most important considerations when looking at changes to your business models?

On a scale of 1 to 5, where 1 is not an issue and 5 is a top priority



Source: EY and The Banker survey

INTRODUCTION

economy, for those who are ready to take on assets that the largest banks now regard as non-core. That could be private equity or alternative investment funds, or the specialised challenger banks. We've developed analytical capabilities to handle regulation, and our own treasury has the experience of raising and managing capital. It is right that we should bring this expertise and understanding to smaller banks that do not have the same capacity," says Mr Thurman.

NON-BANK PARTNERS

Mr Thurman acknowledges that there are many non-bank investors who now regard the large banks as sources of assets to buy, because banks themselves cannot hold those assets and generate an acceptable return. Lloyds itself sold its social housing loan portfolio to its former subsidiary, pension provider Scottish Widows, combining the origination expertise of Lloyds Bank with the Scottish Widows annuity book.

"Developing partnership models, like we've done with Scottish Widows, supports relationship managers across the bank to deliver the full capacity of the group to our clients and ultimately benefit the wider economy. It remains key that we tackle these new approaches in a disciplined way that does not involve diluting our own customer proposition. It's a question of keeping to a simple business model anchored in the needs of clients, but of course that's easier to say than it is to deliver," he says.

Mr Meijer says the gap in price expectations between non-bank buyers and bank sellers has begun to narrow. "There were US hedge funds and private equity funds that raised a lot of money in 2009 and 2010 expecting to make a quick profit buying portfolios from European banks at knock-down prices because of the eurozone crisis. That did not happen. A successful buying strategy involves putting in the due diligence, building the capability to wind down assets faster than the bank, or even using the acquisition as a bolt-in – for instance, by placing a portfolio that comes with a client-servicing platform into an insurance environment," he says.

IMPROVING EFFICIENCY

Mr Butler says Prime Markets is looking at moving into medium-term lending backed by securities collateral, an area neglected by the mainstream banking sector. However, the role of non-banks extends beyond simply taking unwanted assets from bank balance sheets. "There is an exodus of banks from non-core businesses, but even in areas where they remain active, banks can make huge



WE HAVE TO STAY FOCUSED ON CLIENT NEEDS AND AVOID BEING OVERLY DISTRACTED BY THEORETICAL OUTCOMES

Edward Thurman ●●

cost savings by using other players for certain activities, for example, by using independent brokers for distribution," he says.

Here again, regulation is interacting with other trends, especially the rise of electronic platforms in wholesale banking and markets businesses. Mr Meijer says the weaker earnings environment has focused minds on how the rise of electronic trading affects the banks. It did not initially lead to significant staff cuts, but today banks are looking to cut headcount, or transfer more staff to middle and back-office functions to tackle the greater burden of regulation and compliance. "If and when business picks up, banks will look to increase financial market capacity via greater technological efficiency, rather than extra staff," he says.

Of course, technology projects will also be essential to meeting the challenge of regulation. Mr Bedford expects a much closer alignment between risk, capital and financial management. He says some banks are already looking at creating a specific function, effectively a chief capital officer, to aggregate views of financial and risk data, and supervisory stress tests.

"Financial forecasts now need to integrate stress tests, so it is critical for the two functions of finance and risk to speak the same language, which is a challenge because the two activities

have grown up separately," he says.

He identifies several areas where banks are undertaking core capability projects to make that switch, including intra-day liquidity management, optimising collateral management and some capability for more dynamic capital allocation, both geographically and across flow, cleared and uncleared financial market products.

CROSS-BORDER PROSPECTS

Capital allocation in international banking groups is one of the more difficult challenges. Regulators still appear torn between the greater efficiency of bank resolution policies that rely on the home supervisor to resolve the bank – so-called single point of entry – and the desire to protect the integrity of bank operations in their own jurisdiction.

"International banks might rather have a branch in a lesser location than be required to open a subsidiary in a larger financial jurisdiction. That sounds bold, but if you step back and look at it from the point of view of a global investment bank that wants to be profitable in a constrained environment for capital, collateral and liquidity, you want to be able to manage those items on a cross-border basis. In that context, the last thing you want is to be forced into a subsidiary. But it also comes back to what clients want in terms of a locally regulated subsidiary versus a well-capitalised group with a branch through which they do business," says Mr Bedford.

Raiffeisen recapitalised its Russian subsidiary after the 1998 government default and banking crisis, and has since earned considerable profits from the unit. Mr Butler contrasts this with banks today exiting markets such as Greece at the very bottom of the cycle. "The reality of scarce and expensive capital means that banks and their owners are not willing to suffer the pain in order to enjoy the potential upside, and mistimed acquisitions are no longer tolerated – banks just want to cap the losses," he says.

Nonetheless, Mr Thurman believes cross-border banking is still a strong business model provided banks keep to the acid test of client needs. The payments business in the international arena is an excellent example of serving those needs. "There has been some retreat from international banking, and that means we have to do more with fewer partners, and stay focused on the mutual benefits for ourselves and our correspondent banks. The greater compliance and anti-money laundering requirements are also pushing in that direction, we need to rationalise our networks and ensure a robust process of choosing who we work with and why," he says. **FB**

FIXING THE RESOLUTION PROBLEM

Recovery frameworks

European regulators have been trying to create resolution and recovery frameworks that will enable them to wind down failed banks without using taxpayers' money. So far, they have not succeeded. But, as Paul Wallace reports, few bankers are quibbling with the progress made.

THE FALL OF LEHMAN BROTHERS in September 2008 still haunts bank regulators. Throughout Europe, officials are working to put in place plans that would enable big banks to go broke without causing the chaos that ensued after Lehman's demise.

Producing credible recovery and resolution frameworks is proving tough. The process involves not only trying to coordinate among national regulators, who often barely disguise their distrust for one another, but shaking up the very structure of banks.

EUROPEAN PROGRESS

In Europe, two major commissions have proposed radical changes to banks' business models in an attempt to make the financial system safer, by both bolstering the strength of individual institutions and making sure there is little contagion if they do happen to collapse. The Liikanen Report, headed by Finnish central bank governor Erkki Liikanen to cover the EU, proposed several measures in October 2012, including separating banks' trading and deposit-taking operations and using bail-in debt instruments as a resolution tool. The Liikanen Commission was set up shortly after the UK's equivalent, the Independent Commission on Banking (ICB), suggested that banks ring-fence their retail arms from their investment banking divisions.

As yet, regulators cannot claim to have resolution frameworks that would work if put to the test. "Do I think the problem has been solved yet? No, it hasn't," says John Liver, head of global regulatory reform at EY. "There's a lot of detail to be worked through before we can say that we've got close to solving the issue of too big to fail. I wouldn't belittle the progress that's been made on the principles. It's just that if a big bank were to fail today, you couldn't say that taxpayers would definitely be off the hook. The building blocks are yet to be put in place."

Like Mr Liver, however, many senior bankers are sanguine about the progress made



THERE'S A LOT OF DETAIL TO BE WORKED THROUGH BEFORE WE CAN SAY THAT WE'VE GOT CLOSE TO SOLVING THE ISSUE OF TOO BIG TO FAIL. *John Liver* ●●

by European officials so far. "What has been achieved in Europe in the past 18 to 24 months is unprecedented," says Julius Baer's Marco Mazzucchelli, who used to be the deputy head of Royal Bank of Scotland's investment bank and was a member of the Liikanen Commission. "The individual measures might not be perfect. But taking them altogether, we are very close to having a new regulatory and supervisory framework for the European banking system that is fit for purpose."

CONFLICTING STRATEGIES

Bankers still fear, however, that countries could implement conflicting recovery and res-

olution directives. Their concerns are fuelled by the fact that regulators, both globally and within Europe, have shown far less coordination regarding how banks should structure or resolve themselves than they have regarding new capital and liquidity requirements. "Even within the EU, there are understood to be disagreements between some neighbouring regulators on how to deal with the resolution of cross-border banks," says Emil Petrov, head of capital solutions at Nomura.

There are some principles that seem to have been universally agreed upon. One of those is that bail-in debt – debt that can be written down or converted to equity at the point a bank runs into trouble or is deemed non-viable – will be a significant part of the answer to the resolution problem. Plenty of uncertainty surrounds the exact form of bail-in debt European regulators will eventually require their lenders to have. But analysts see little reason for policy-makers not to emerge in favour of such debt instruments, which will have the effect of making it easier for them to take over failed banks without putting their taxpayers' money at risk.

"With bail-in, the concept is that a government would be in a position to take over a failed bank and work it down while imposing losses on creditors," says Bill Winters, the chief executive of asset manager Renshaw Bay, former joint head of investment banking at JPMorgan and ICB commissioner. "This would make it more likely that the government would intervene in the first place."

More broadly, there is a push towards splitting banking businesses seen as risky from those deemed less so. Both the Liikanen and ICB commissions proposed, albeit in different ways, the separation of deposit-taking arms from those carrying out trading and investment banking activities. Taking their cue from Liikanen, UBS and Credit Suisse each announced plans in 2013 to create Swiss subsidiaries by mid-2015, which they said >>



THE TWO MAJOR STRUCTURAL ISSUES THAT STILL NEED TO BE DECIDED, PROBABLY IN THE NEXT YEAR, ARE THE SEPARATION ISSUE AND THE PHILOSOPHY OF BAIL-IN

Jan Pieter Krahnem ●●

would make it easier for them to be wound down in the event of a severe crisis.

Mr Mazzucchelli believes such moves will become more common among European banks. But he says that it does not spell the end of universal banking models. The intention of the Liikanen report, he says, was to advocate separation of business lines in terms of capital and funding, but still allow banks to carry out universal banking activities under a single holding company.

SUBSIDIARISATION CATCHES ON

Others agree, saying that local regulators, wary about the failure of a foreign bank with operations in their country, will also demand some form of separation. "There is definitely retrenchment from the pre-crisis model where firms could manage businesses pretty freely, cutting across jurisdictions and with heavy deference to home supervisors," says Stefan Walter, leader of EY's global regulatory network and former secretary-general of the Basel Committee on Banking Supervision. "Now you have host supervisors setting a range of additional demands and institutions therefore no longer just managing themselves globally by business lines."

Closely linked to this so-called subsidiarisation is whether supervisors adopt a single or multiple point-of-entry approach to bank resolution. The former would create a greater role for the holding company, whereas a multiple entry process would involve a bank making its businesses self-funding in each jurisdiction so that they can be allowed to fail on their own. For cross-border banks with big wholesale divisions, which are typically harder to ring-fence than retail businesses, having to adapt to multiple point-of-entry regulations would be complicated.

"The debate about single versus multiple point of entry into resolution will have greater implications for the more complex cross-border institutions," says Nomura's Mr Petrov. "Some of these may have to re-organise their corporate structures or capital-raising and funding models, including, for example, by raising more capital and bail-inable debt locally to suit a multiple point-of-entry approach by regulators."

NOT SO LIFE AND DEATH

Over the next year, Europe's bankers and analysts hope for more clarity about how regulators intend to implement rules that will affect their structures and operations. "There is still too much uncertainty about the final shape of the new regulatory requirements," says Jan Pieter Krahnem, a professor

of finance at the Goethe University and a member of the Liikanen commission. "There is an understandable hesitancy among banks to act quickly in a direction that might later prove unnecessary. The two major structural issues that still need to be decided, probably in the next year, are the separation issue and the philosophy of bail-in."

Devising credible risk and resolution strategies is seen as essential for European banks. "If a bank can fail in an orderly way, the prevention of failure becomes less of a life-and-death situation," says Mr Mazzucchelli.

Moreover, for banks in the eurozone, a failure to create a working resolution regime would imperil the planned single supervisory mechanism, under which the European Central Bank will later this year assume responsibility for specific tasks relating to the bloc's systemically important banks.

The history of banking crises – not least that started by Lehman's bankruptcy – suggests that regulators will work in their national interests when they come to dealing with failed institutions. There is no guarantee that will change should a major, cross-border European lender need rescuing in future. Yet bankers are on the whole optimistic that trust between supervisors in different countries can be built.

Mr Winters says there is a genuine desire in Europe to eliminate national bias and create a centralised resolution strategy. The obstacles, he believes, are more to do with how to fix the mistakes of the recent past. "There's an underlying desire to create a proper eurozone banking system, with a single regulator and set of rules," he says. "The impediment is the cost of the clean-up of the past, not the vision for the future. All the haggling right now over bank bailouts seems to be over who picks up the bill for the mistakes of the past decade."

If European officials cannot agree in the near future about how to save failing banks, there is at least a silver lining. All the capital increases they have forced on the continent's lenders since 2008 should make the chances of them having to test their recovery and resolution strategy that much slimmer. "Clearly, the sector has significantly increased its resilience since 2008," says Jon Peace, head of European banking research at Nomura. "There has been a big increase in the amount of capital and the core capital ratios. But when you look at how difficult it has been to set up a single banking union, it suggests that the execution of any resolution would be unpredictable. Hopefully, however, the chances of us finding out are far lower than they were in the past." ^{1B}



BIG DATA HELPS TACKLE BIG REGULATION

Big data

Regulatory demand for greater insight into banks has pushed financial institutions to seek out scalable and low-cost data processing, writes Dan Barnes.

THE NUMBER OF CHANGES BANKS FACE as a consequence of regulation are enormous. By way of example, as of December 2, 2013, 280 rule-making deadlines have been passed for the wide-ranging Dodd-Frank Act in the US, since it was signed off in July 2010. While few jurisdictions are as advanced in their own rule making, nevertheless regulators across the globe are asking for more granular levels of information, on a more frequent basis than ever before.

Such demands are testing the limits of database technology and so banks are examining new platforms that can accommodate and process data sets that could not be run through a traditional database, so-called 'big data' technology.

"There are some areas where we are seeing big data being applied in its purest sense," says Dan Higgins, financial services partner at consultancy EY. "It is early days, but banks need to change their technology model. There are some that are beginning to take the big data concept and apply it in

anti-money laundering [AML] and compliance functions, using what they call meta-alerting. They combine holistic alert data, unstructured external sources and so on, to produce a better informed view of the client and the transaction."

OPENING DOORS

By allowing unstructured data sources to be checked in parallel, distributed across many low-cost servers, big data technology makes a faster and cheaper alternative to old models of data storage and retrieval, while opening the doors to a greater range of information sources. That can make risk calculations faster, cheaper and more flexible.

"There has been an explosion in what is possible in data and analytics," says Alasdair Anderson, global head of IT architecture at HSBC securities services. "For 20 years there have been relational database management systems and nothing else. Then a couple of guys in Silicon Valley said, if you were able break out of that mould and could scale a pro-

cess with different kinds of data and greater amounts of data, and run 'what if' analyses across it, then you have a whole business creating product out of data. That is one of the key technology trends that we are seeing."

The extent to which banks are under pressure from new rules varies by geography. The US is admittedly ahead of the curve; Dodd-Frank is the spearhead of post-crisis capital markets reform. Europe and Japan are still hammering out the details of their equivalent market reform regulations, while other countries are discussing how to respond.

Capital adequacy rules have been more widely adopted. By April 2013, 14 of the 27 Basel Committee member countries had issued Basel III-based capital regulations, acting at a major driver for data management reform.

"Everything that has to do with Basel is a big driver, especially the Basel Committee on Banking Supervision regulations around risk aggregation reporting," says Hyong >>



THE SMARTER BANKS ARE SAYING: 'WE TRIED TO DO THIS WITH SQL AND WE CANNOT' *Mark Whitehorn* ●●

Kim, financial services partner at EY. "There are new kinds of data capture, new data quality measures and new kinds of reporting. Clients are using that as a driver to re-optimize their data infrastructure."

CAUSE FOR COMPLIANCE

The burden of compliance with new rules so far falls upon firms operating in well-developed markets, as these countries are typically in the lead when it comes to enacting new post-crisis policy. In addition, the more expansive a firm's operations, the more regulations it must comply with. But authorities are increasingly making examples of firms that transgress existing rules. Their enforcement of AML rules and the beefing up of anti-tax evasion programmes has led to massive fines for banks found wanting.

In 2012, HSBC was hit with a \$1.9bn fine for allowing cash to cross into the US from Mexico with inadequate checks in place. The same year, Standard Chartered paid \$667m for processing transactions connected to Iran during a period in which the country was under economic sanctions. ING also paid \$619m for historical breaches of AML and know your customer rules in 2012.

Authorities would have the ability to ban firms from continuing to operate in the US should they be perceived as unrepentant or repeat offenders, and that is driving them to make their processes watertight. Meta-alerts would enable banks to track individuals between geographies, using a wide range of data sources to check that they are who they claim to be and monitor their activity in order to identify suspicious behaviour, minimising any chance of a criminal transaction slipping through.

"There is a philosophical change as to what constitutes relevant data to be analysed, and there is a tooling change that is required to the traditional architectures to allow for more efficient processing of very diverse, higher volume and more loosely connected data," says Mr Higgins. "It doesn't stop at the technology model. If you bring all of this together it requires a skill and capability change as different skills are needed to architect informational transactions as well as financial transactions."

NEW MODEL DATA

What will enable banks to manage this data montage is precisely a breakaway from the adaptation of financial transaction data models and associated hardware.

"Things such as AML or understanding your customer are all about spotting patterns over time," says Professor Mark White-

horn, chair of analytics at the school of computing at the University of Dundee.

This is not what SQL (structured query language) relational databases, which banks use for tracking and recording financial transactions, are best at. Structuring a search in SQL requires a skilled programmer and can be time intensive. Instead, models such as Apache Hadoop, an open-source platform that was based on the Google storage and retrieval system, are being investigated, as they allow searching across much more varied sources of data, with searches constructed far more simply, just as one sees in search engines.

"The smarter banks are saying: 'We tried to do this with SQL and we cannot,'" says Mr Whitehorn. "In fact, you can do anything with SQL but at some point it becomes so hard to do it with SQL and so much easier to do elsewhere, there is no good reason to continue with SQL. It's a matter of cost versus payback."

A QUESTION OF TRUST

As open-source technologies are typically not tried and tested to an industry standard, they are not stable enough for banks to trust with sensitive data. As a result, banks are at early stages of development with Hadoop-based technologies, exploring how they can best interact with existing database and data warehousing installations.

"Once you have built up expertise with things such as Hadoop, you can do some interesting things," says Mr Whitehorn. "Data from a data warehouse is assumed to be clean, audited and has an agreed meaning. Without those three, any analytics is worthless. There is a lot to be said for taking the data from a data warehouse and writing queries for it in Hadoop, because it is orders of magnitude easier than writing them in SQL."

To effectively build these technologies into their architectures, firms need to develop a strategic model approach to data management that will allow an evolution of existing platforms, and an integration of new systems.

"Banks are seeking to deliver enterprise-wide data governance and so they are creating chief data officer functions to take responsibility for managing data standards, data policy and compliance with those policies," says Mr Kim. "Those functions are looking at various components around the solution and are responsible for defining the data architecture across the bank. These enterprise data architectures are being used as the blueprint for pulling together information needed for each regulation and defining how each reporting obligation will be met." ^{TB}

BASEL: GOING FOURTH?

Capital adequacy

Basel III is upon us. Although banks appear to be coping well with the capital-related elements of the regulations, Michael Imeson finds that they are having to make fundamental changes to the way they do business – and a ‘Basel IV’ looms on the horizon.

THE FIRST PHASE OF BASEL III came into effect for EU member states this month through the Capital Requirements Directive (CRD) IV, and other countries around the world have also started to implement it. Banks have until 2019 to meet all the requirements, and the signs are that the vast majority will have little trouble in doing so, but they are having to make big changes to their business strategies and operating models, especially because of the tougher rules on capital adequacy.

Basel III's broad objectives, drawn up by the Basel Committee on Banking Supervision, are well known. They are to improve the banking sector's ability to absorb shocks arising from financial and economic stress by applying stricter capital and liquidity requirements; to improve risk management and governance; and to strengthen banks' transparency and disclosures.

CAPITAL REQUIREMENTS

This article is concerned only with the capital requirements of Basel III. In that respect, the goal is to improve the quantity, quality, consistency and reliability of bank capital ratios around the world. Under the new framework, the minimum capital requirement remains at 8% of risk-weighted assets (RWA) – as it was under Basel II – but 4.5% of that must now be common equity Tier 1 (CET1), the highest quality capital, compared with only 2% under Basel II.

But 8% is not really the minimum any more, as there are several capital add-ons:

- A capital conservation buffer, which must be CET1, of 2.5%. This brings the minimum to 10.5%.

- A surcharge for global systemically important banks (G-SIBs), which must also be CET1, ranging from 1% to 3.5%, depending on a bank's systemic importance. This will increase the minimum for G-SIBs to 11.5% to 14%.

- A countercyclical buffer, which again must be CET1, ranging from 0% to 2.5%. This is to



OVER TIME, BANKS WILL SHIFT TO WHERE THEIR COMPETITIVE ADVANTAGE IS AND RE-PRICE CERTAIN PRODUCTS TO GET ACCEPTABLE RETURNS. THERE WILL BE A SHIFT TO BUSINESSES THAT USE LESS CAPITAL, ARE MORE FEE BASED AND ATTRACT LOWER RISK WEIGHTS *Peter Davis*

be applied when the authorities decide that credit growth is creating an unacceptable build up of systematic risk. At the highest rate, it would increase the minimum to 13% for most banks, and 16.5% for banks subject to the higher G-SIB surcharge.

In addition to these add-ons, which will be phased in between now and 2019, there are two other key capital requirements:

- Capital loss absorption at the point of non-viability: in other words, capital instruments must include a clause that allows regulators to write them off, or convert them to common shares, if the bank is judged non-viable.

- A minimum 3% leverage ratio on all of a bank's assets (including off-balance-sheet items), without any risk weighting. This serves as a backstop to the risk-based capital requirements.

These rules are not binding on countries – it is up to the regulatory authorities in each country to implement them within their jurisdiction – but there is expected to be little deviation.

BE BETTER, NOT RICHER

In his just-published book *Heads or Tails: Financial Disaster, Risk Management and Survival Strategy in the World of Extreme Risk*, Evgueni Ivantsov of Lloyds Banking Group argues that the Basel Committee missed the point by focusing on capital. They should have dealt with weaknesses in risk management.

“Normally, financial institutions fail not because they have insufficient capital, but because they suffer unbearable losses,” writes Mr Ivantsov. “They face losses because they cannot manage extreme risk properly by opting for reckless business strategies, flawed business models or by making unforgivable mistakes. I don't dispute the idea of sufficiency of capital, but loss absorbency is no more than an ‘airbag’ and ‘seat belt’ for the banking industry's passengers. Yet regulators keep on referring to the same mantra: more capital, more capital, more capital.”

That ‘crash protection’ comes at a huge cost. Recent estimates suggest US and European banks will need about €1700bn of additional Tier 1 capital, €1900bn of short-term liquidity and about €4500bn of long-term funding to meet Basel III rules.

In an interview with *The Banker*, Mr Ivantsov, who is head of portfolio management and strategy at Lloyds Banking Group, and chairman of the European Risk Management Council, explains how banks have been able to meet the new capital rules, despite the cost. “They have done it in two ways,” he says. “First, they have reduced their risk-weighted assets, the denominator in the capital ratio, by exiting many of their businesses, often non-core ones. They have also taken a more pragmatic approach, shifting their lending activity from capital-hungry assets to assets with lower risk weightings. I would estimate that European banks have reduced their risk-weighted assets by circa 10% since 2011.

“Second, banks have accumulated more capital, the numerator in the ratio. They >>>



I BELIEVE THAT IN TIME, THE BASEL CAPITAL ACCORD COULD USEFULLY BE RECAST SO THAT IT HAS DISTINCT COMPONENTS FOR GOING-CONCERN AND GONE-CONCERN REQUIREMENTS *Paul Tucker*

have done this mainly by retaining more of their earnings – by paying out lower or no dividends. In addition, some banks have raised more equity capital via rights issues.

Meeting the capital requirements is only half the story. The other half is trying to run a profitable business when so much capital is tied up. “Before the crisis, the average return on equity [ROE] for banks in developed countries was about 15%,” says Mr Ivantsov. “Immediately after, it was in the region of 0.5%. By the end of 2012 it had risen to 6%. Now, most banks are working on ROE targets for the near future of 8% to 10%.”

RE-EVALUATING BUSINESS MODELS

The need for banks to change their business models as a result of Basel III was a theme in the fourth annual study of risk management in banking and insurance, carried out in 2013 by EY in conjunction with the Institute of International Finance. Seventy-six firms from 36 countries took part.

“Our survey showed that banks are under a lot of pressure to mitigate falls in ROE following the capital increases,” says Patricia Jackson, head of financial regulatory advice at EY. “As a result, 81% of respondents said they are evaluating portfolios, and 44% said they are exiting lines of business, up from 29% on 2012.”

The survey showed that capital management is being rethought. With regulatory capital now much higher than economic capital, 55% of respondents said they are aligning capital allocation with regulatory capital. “It’s an enormous re-evaluation of business models,” says Ms Jackson.

The retreat by banks from many activities – such as infrastructure lending, project finance and energy finance – is creating a gap that is increasingly being filled by the shadow banking sector. Ms Jackson has written a chapter on shadow banking in a book – *50 Years of Money and Finance* – just published by Suerf, the European Money and Finance Forum. “The Basel III capital and liquidity buffers and wider uncertainty regarding future regulatory change have led to deleveraging and this in turn is leading shadow banking again to grow,” she writes.

Although Basel III has created scope for regulatory arbitrage between financial sectors – banking and shadow banking – there is unlikely to be similar arbitrage between countries, because Basel III is being implemented consistently by the world’s major economic powers. “You hear talk about banks being able to exploit differences in regulatory requirements between coun-

tries, but I think it is a chimera,” Ms Jackson tells *The Banker*. “All jurisdictions of any size are tough.”

Peter Davis, head of financial risk management services in North America at EY, says that US banks are following the global trend to move out of capital-intensive and highly leveraged businesses. For US banks with leverage constraints, repos will be one of the businesses most affected.

“In the US we expect a rule to come out soon that will require banks to hold some long-term debt at the group level to act as an additional cushion against failure,” says Mr Davis. “Over time, banks will shift to where their competitive advantage is and re-price certain products to get acceptable returns. There will be a shift to businesses that use less capital, are more fee based and attract lower risk weights.”

BASEL IV LOOMING

Many people believe that a Basel IV is a strong likelihood. That is certainly the view of Paul Tucker, former deputy governor of financial stability at the Bank of England, and now a senior fellow and member of the finance unit at Harvard Business School. In a speech given just before he left the Bank of England in October, he raised the prospect of a revision to the Basel capital framework to distinguish between capital that can absorb losses when a bank is a going concern – namely equity – and capital that can smoothly absorb losses when the bank is a “gone concern” and goes into liquidation.

“The recent G20 leaders’ summit called on the Financial Stability Board to produce plans over the coming year for the level and location of gone-concern loss-absorbing capacity in global banks and dealers,” said Mr Tucker, who while at the Bank of England was also a member of the Financial Stability Board’s steering committee. “In a nutshell, this will be a policy for the amount of term-bonded debt issued by banks, and where in the group structure it is issued from.

“I believe that in time, the Basel Capital Accord could usefully be recast so that it has distinct components for going-concern and gone-concern requirements. That would replace what to my mind is the fuzzy distinction between what are termed ‘common equity Tier 1’, ‘additional Tier 1’ and ‘Tier 2’ capital – not all of which is capital in the ordinary sense of the term that it can absorb losses outside of liquidation.”

If Mr Tucker is right, those who had hoped that Basel III would be the end of the matter will have their hopes dashed. **FB**



Cutting corners: many banks are reassessing their methods of risk control, prompted by the recent spate of fines issued by regulators

CONDUCT, REPUTATION AND CONTROL

Risk culture

Conduct risk and reputational risk are receiving more attention from banks than ever before as they strive to gain better control over their activities. Michael Imeson reports.

THE CONDUCT AND RISK CULTURE of banks has improved significantly in the wake of the financial crisis and the many misdemeanours that have happened since, such as rogue trading, product mis-selling and Libor-rate rigging. The change of attitude has been driven not only by the regulatory response, but by a realisation among bank boards and senior management that they had to mend their ways.

It was obvious after the events of 2008 that banks needed to enhance their credit and market risk management, and set aside more capital and liquidity to support their activities. But more recently it has also become clear that they should place more emphasis on managing the non-financial operational risks – in particular ‘conduct risk’ (the risk of acting unethically or illegally) and ‘reputa-

tional risk’ (the risk of damaged or destroyed reputations resulting from poor conduct).

The responsibility for controlling all the risks generated by a bank’s activities is a wide one. It goes beyond the remit of the chief risk officer (CRO) and the risk management function; it is a risk governance issue.

In other words, the board of directors and senior management now have to take full responsibility for risk, with proper interaction, cross-checking and transparency between all parties. Only then can a bank’s leaders claim to be in control. Clearly some of the world’s biggest banks are still out of control, as evidenced by the €1.7bn in fines handed out by the European Commission in December 2013 to several banks for forming cartels for manipulate Yen Libor and Euribor rates.

DEFINING RISK APPETITE

The Financial Stability Board (FSB) is trying to help banks in this respect. In November it published two papers. The first, Principles for an Effective Risk Appetite Framework, lays down what the FSB believes should be the key elements of such a framework, and how the authorities should supervise it. For example, a risk appetite framework should:

- Set the aggregate level and types of risk a financial institution is willing to assume within its risk capacity to achieve its strategic objectives and business plan.
- Set out the overall approach – policies, processes, controls and systems – through which risk appetite is established, communicated and monitored.
- Be driven by both top-down board leadership and bottom-up involvement of management at all levels, and embedded and understood across the financial institution.
- Be embedded into the financial institution’s risk culture.

The second paper, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, is a consultation document, open for comment until January 31, 2014, which seeks to help financial institutions understand their risk culture, and how it should be supervised.

“Failures in risk culture are often considered a root cause of the global financial crisis as well as headline risk and compliance events, for example the London whale [and] Libor manipulation,” states the paper. “A financial institution’s risk culture plays an important role in influencing the actions and decisions taken by individuals within the institution and in shaping the institution’s attitude toward its stakeholders, including its supervisors.”



BANKS SHOULD ASK THEMSELVES A VERY SIMPLE QUESTION: ARE WE IN CONTROL OF THESE RISKS? MANY OF THEM ARE NOT

Pierre Pourquery ●●



REGULATORS GET TOUGH

The FSB only offers principles and guidance. It is the national regulators that write the rules, enforce them and mete out the justice when they are flouted. The UK's new Financial Conduct Authority (FCA), for instance, has just fined Lloyds Banking Group £28m (\$45.57m) for serious failings in its controls over sales incentive schemes. It is the largest ever fine imposed by UK financial regulators for retail conduct failings, and the reputational damage done to the bank is immeasurable.

"The incentive schemes led to a serious risk that sales staff were put under pressure to hit targets to get a bonus or avoid being demoted, rather than focus on what consumers may need or want," said the FCA in describing the culture of mis-selling at the bank. In one case an advisor sold protection products to himself, his wife and a colleague to prevent himself from being demoted.

Pierre Pourquery, partner and European lead for risk and regulatory strategic solutions at EY, says European and US regulators are exerting pressure on banks on everything related to conduct and the control environment. "It's causing banks to take risk culture more seriously. It is really changing their mind-set, making them much more risk aware than before."

Banks began to take a methodical approach to operational risk management after Basel II, but they tended to focus on IT systems and processes, taking a heavily quantitative approach and not properly embedding it in the business. Now they realise that operational risk includes poor conduct and lack of control.

BEING IN CONTROL

"Banks should ask themselves a very simple question: are we in control of these risks? Many of them are not," says Mr Pourquery. "On the one hand they have quantitative data on operational risk, which is of limited value. On the other hand they have some kind of control assessment, but it is done as a self-assessment so is extremely subjective and not based on a standard.

"CROs need to ensure they are in control. Defining the standard that needs to be attained is the first step. Then you can assess whether you have the right controls in place to meet that standard.

"Once you understand the gap between your position and the standard, you can decide what to do. You can accept the gap, but more banks are not accepting the gap, which gives you two further options: make some improvements, or cease the activity you are engaged in."



MANY OF THE LARGER BANKS HAVE CREATED THE SPECIFIC ROLE OF DIRECTOR OF CONDUCT RISK, OR HEAD OF CONDUCT RISK

Jenny Clayton ●●

FRAGMENTED VIEWS

This is easier said than done. The main problem is that the CRO gets fragmented views from different departments – from the operational risk department, the audit department, and the business lines. The data coming out of these different silos needs to be integrated.

"Historically, no one has had the role of integrating these different pieces of information," says Mr Pourquery. "But such a role is now emerging, that of the chief control officer, the CCO. That person's role is to define the standards, and then integrate all the risk data so that the key question – 'Am I in control?' – can be answered accurately."

Jenny Clayton, partner and retail banking lead in the risk practice at EY, explains that the large UK banks have set up 'conduct risk' programmes of work. This is largely in response to the risk mitigation activities prescribed by the FCA, and prior to that the Financial Services Authority.

"Many of the larger banks have created the specific role of director of conduct risk, or head of conduct risk," says Ms Clayton. "That elevates the importance of conduct risk as a class of risk. These programmes centre on the business strategy, culture and controls of the organisation. There is a focus on demonstrating how strategy is complementary to conduct, and how the strategy embeds the philosophy of putting the customer at the centre of decision making."

WHAT BANKS HAVE TO SAY

Frank Stöfer, head of credit risk management at Helaba, one of the larger German landesbanken, explains that the bank's risk function was strengthened when a new CRO joined a year ago. "We also have a risk-controlling executive and, due to the increase in regulatory reporting requirements, the CRO and the chief financial officer co-operate more closely these days."

Mr Stöfer is at pains to point out that conduct and reputational risk is not as big an issue for landesbanken as it is for global banks. Even so, Helaba is among the many eurozone banks that is being subjected to the European Central Bank's risk assessment, asset quality review and stress-tests, due to be completed in October 2014. The exercise is bound to have an impact on banks' risk management frameworks.

"It's early days, but it is a fair assumption that standards will be raised in terms of how prudently banks look at their exposures and how consistent they are with exposures, valuations and methodology," says Mr Stöfer. "Everything has to be consistent and logical so that third parties can easily understand it."

BARCLAYS' CHANGE IN CULTURE

Barclays is one of the global banks whose reputation has been badly damaged by its past conduct. It was constantly in the news in 2012 for unethical behaviour, resulting in the departure of its chief executive, chairman and other senior directors. It is now trying harder than most to change its culture and ethics.

Under the stewardship of new chairman Sir David Walker and new chief executive Antony Jenkins there has been a massive cultural change at the top which seems to be permeating down. In 2013, it announced a strategic review, Transform, which, among other things, defined new 'purpose and values' and aimed to ensure that its business activities would not have a negative impact on the bank's reputation.

In a recent speech, Mr Jenkins explained that the bank had also taken a number of "de-risking actions", to make it "less susceptible to mistakes of the past such as mis-selling and other forms of conduct risk". These de-risking actions included closing the personal financial planning business in the UK, closing its structured capital markets tax planning and advisory unit, and eliminating sales incentives in the branch network.

"These and other actions reduced revenues in the short term, but I believe that they are a critical part of ensuring long-term revenues are more sustainable and of reducing the risk of conduct issues in the future," said Mr Jenkins.

What banks are doing to improve their culture and exercise greater control over their activities is commendable. Big questions remain though. Will fine words about adopting high moral values and de-risking really make a difference? How easily can bankers, and the banks they work for, modify their ways? If leopards cannot change their spots, can bankers change their conduct? **IB**