Global Regulatory Network

2018 annual bank regulatory outlook

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Time to face the future

With the approval of "Basel IV" in early December 2017, regulators put the finishing touch on post-crisis reforms in prudential regulation. At the global level, policymakers have effectively drawn a line under dealing with the problems of the past. If the same problems were to arise again, banks and the financial system as a whole would be better prepared to deal with them. Banks are more resilient, and the financial system is more robust.

Although authorities plan to conduct a review of post-crisis reforms, banks should not expect a respite from regulation. While small banks may receive some relief, there is little prospect of legislation that would roll back regulation significantly. In fact, pressure on large banks is likely to increase, as supervisors around the world each implement their own particular version of the Basel reforms and other international accords, as regulators tighten market standards (see "Making markets robust, efficient and fair" box) and as authorities reset rules in response to new technology.

Further pressure will come from investors. They are demanding that banks return capital, either through dividends or buybacks. But to do so, banks have to increase their returns on capital. That will require them to do more with less. This note outlines the "more" that supervisors expect, as well as how banks can get the job done with the "less" that investors demand, all during the window of opportunity afforded by the current recovery.

Building a better working world

The post-crisis reforms in prudential regulation

Overall, the post-crisis reforms have made banks less likely to fail as well as easier to resolve, if they do reach the point of non-viability. They have made markets more robust, efficient and fair (see "Making markets robust, efficient and fair" box. The reforms have forced, and will continue to force, banks to increase capital, augment liquidity, improve governance, sharpen controls and alter their structure.

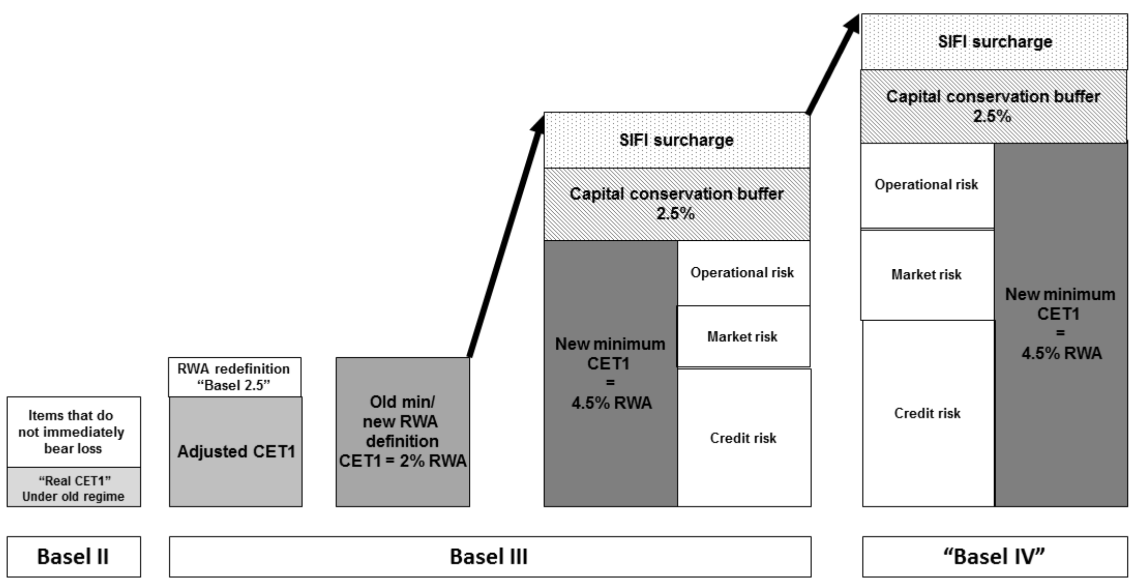
This "must-do" agenda continues to be a tall order for banks, especially the global banks at the core of the financial system. Not only do they have to meet the impending implementation deadlines for rules adopted some years ago, but they also have to contend with the possibility that both investors and supervisors may front-run the deadlines for implementing Basel IV. Indeed, investors are already demanding that banks disclose their key ratios on the basis of the fully implemented final rules. And, supervisors may again choose to use the final rules, rather than the interim standards, as the basis for stress-testing.

Perhaps most importantly, each post-crisis reform is not a single order, but many. Each major jurisdiction is adapting the Basel agreements to reflect its own preferences and practices. This fragments finance, lowers liquidity, restricts resolvability and erodes efficiency, just at the time when new entrants are using new technology to challenge banks' business models.

Strengthening capital

Strengthening bank capital is the cornerstone of post-crisis reforms. Higher going-concern capital makes banks less likely to fail; greater gone-concern capital makes them easier to resolve.

Figure 1
If and when implemented, Basel III and "Basel IV" will substantially increase capital requirements



CET1 Common equity Tier 1 capital

RWA Risk-weighted assets

SIFI Systemically important financial institution

Whether it is the final stage of Basel III (the official view) or "Basel IV" (the banks' view), the Basel Committee on Banking Supervision's December decision effectively completes the reform of going-concern capital requirements (see Figure 1). Overall, reform has strengthened the definition of capital, raised risk-weighted capital requirements substantially and introduced a leverage ratio as a backstop to the risk-weighted regime. It has also, as part of the resolution agenda, imposed requirements for banks to issue significant amounts of gone-concern capital.

The so-called "Basel IV" package of reforms revises the standardized approach that banks should use to calculate the risk weights that should apply to their exposures to credit, market and operational risk. Although this new standardized approach is more sensitive to risk than the old, it is pitched at a higher level. Moreover, the December decision limits the ability of banks to use their own models. Under the "output floor," the bank's risk weighted assets (RWA) — and therefore its overall capital requirement — can be no lower than 72.5% of the RWA calculated under the revised standardized approach, even if the bank qualifies to use the advanced (internal model) methods and the bank's own models produce a lower result. But this floor will not begin to take effect until 2022 and will only become fully effective in 2027 — provided jurisdictions actually implement the Basel Committee's decisions (see "Fragmenting finance" section).

Banks should not take too much comfort from this. Stress tests have become — and are likely to remain — the binding constraint on banks. The tests enable the supervisor to determine whether banks will continue to meet capital requirements, even if macroeconomic and market conditions deteriorate markedly. If a given bank is unlikely to be able to do so, the supervisor may require the bank to stop dividends and distributions. For extreme shortfalls, the supervisor may require the bank to raise more capital immediately.

Thus, the stress test effectively sets the capital requirement. Key issues for the 2018 stress tests are likely to include the probable increase in interest rates, the shift in accounting (e.g., IFRS 9) to provisioning for credit risk on the basis of expected loss and the impact of tax reform in the US and other jurisdictions. Banks should also expect increased scrutiny of their business models, including how they plan to respond to new entrants and new technology. Scrutiny will be the most intense on those banks that carry concentration risk or large amounts of nonperforming loans. Finally, banks should be aware that some supervisors may elect in 2018 or 2019 to conduct the stress test on the basis of the fully implemented final rules. That would effectively accelerate the implementation of Basel IV.

Improving liquidity

In addition to strengthening capital requirements, the post-crisis reforms have increased liquidity requirements. Key issues for 2018 are the implementation of the net stable funding ratio. This builds upon the introduction of the liquidity coverage ratio as well as requirements that banks improve their ability to measure, model and monitor liquidity risk. In particular, supervisors will expect banks to make significant progress in intraday liquidity reporting as well as in incorporating asset encumbrance and re-hypothecation into their liquidity models and funding plans, both at the group level and for material branches and subsidiaries.

Making banks resolvable

Although increased capital and liquidity requirements make banks less likely to fail, they cannot make banks fail-safe. There is always some possibility that a bank can fail and pose a threat to financial stability. To counter this threat, policymakers have sought to make banks resolvable, or safe to fail.

In theory, policymakers have devised a way to do so. They have the responsibility to develop resolution plans, and the overall approach agreed upon at the Financial Stability Board is largely based on two things:

- Requiring banks to have sufficient gone-concern capital outstanding, so that a bank's bail-in (write-down or conversion to Common Equity Tier 1 (CET1) capital) is sufficient to recapitalize and stabilize the failed bank
- Ensuring in the case of cross-border banking groups coordination and collaboration of the relevant authorities across the jurisdictions in which the group operates

In practice, authorities have succeeded in implementing the first condition, but not the second. In most of the relevant jurisdictions, systemically important banks must maintain a minimum amount of total loss absorbing capacity (TLAC), a certain portion of which should be in the form of gone-concern capital (Additional Tier 1 and Tier 2 capital as well as qualifying senior non-preferred debt). Provided the authorities put a failing bank into resolution promptly (do not exercise forbearance), TLAC should be sufficient to recapitalize and stabilize the failed bank, so that it can continue to perform its critical economic functions without interruption and without taxpayer support.

However, TLAC can't do the job alone. The authorities must play their part. After all, resolution plans are the responsibility of the authorities, not the bank. Although the authorities have formed crisis management groups (CMGs) for the global systemically important banks, there is still much debate about what should be done with respect to certain issues, such as the provision of liquidity to the recapitalized bank in resolution, and who should do it. These groups have not yet found a solution to what might be termed the authorities' dilemma: although all know that cooperation among the authorities would lead to the best result for global financial stability, each authority also knows that in a crisis there is a risk that one or more of the other authorities in the CMG will seek to put its own jurisdiction first. Indeed, most authorities have their objectives defined in purely national terms (e.g., "financial stability in the United States"). Given this risk, authorities are tending to develop resolution plans that focus on resolution of a banking group's entities within their own jurisdiction. Such plans require banks to take steps to ensure the separability and operational continuity of critical economic functions in resolution.

Fragmenting finance

Jurisdictions are therefore employing structural reform to create entities that perform critical economic functions for the domestic economy so that they can be supervised and, if necessary, resolved domestically, without reliance on foreign authorities. Prominent examples of such structural reform include the creation of domestic commercial banks in the UK and Switzerland as well as the US requirement that foreign banking organizations form an intermediate holding company subject to the same prudential standards as domestic banking organizations, including the separation of commercial and investment banking.

Brexit adds further complications. Although the UK has indicated that it will continue to allow branches of foreign banks to operate in UK wholesale markets, it is not yet clear whether or how such entities can continue to interact with clients based in what will become the EU 27.

Finally, the EU itself is considering changes to its banking structure. Although it has dropped plans to separate commercial and investment banking, it is looking to introduce a requirement that a "third-country" (non-EU) bank group its subsidiaries within the EU under an intermediate parent undertaking subject to EU supervision.

Taken together, these efforts are creating a series of self-contained entities that will each operate with its own governance, capabilities and resources, and each faces restrictions on transactions and interactions with other affiliates within the group. Such restrictions may trap capital and/or liquidity within specific entities. This adds to costs and reduces flexibility.

Making markets robust, efficient and fair

Post-crisis reforms have strengthened markets as well as banks, for markets are as important as banks in financing growth and ensuring stability. Indeed, in the US, the EU and various other jurisdictions, plans are underway to promote the development of capital markets.

The objective is to make markets robust, efficient and fair. Under the first heading, authorities have focused on derivatives. Mandatory clearing of over-the-counter derivatives has reduced risk in that market but concentrated the remaining risk in central counterparties (CCPs). Consequently, authorities are likely to continue working to ensure that CCPs are robust (so that they are extremely unlikely to fail) and resolvable (if they were to fail).

Authorities are also working to make markets more efficient and fair. In the EU, Markets in Financial Instruments Directive (MiFID) II became effective on 3 January. This directive aims to drive a significant uplift in investor protection and market transparency. Regulatory guidance on this very complex, new set of regulations for securities markets has continued up to the last minute, and implementation work will need to continue well into and perhaps even past 2018, particularly in light of the applicability of MiFID II to any institution outside the EU that deals with an EU person and the need to reconcile EU rules with rules in other jurisdictions, especially the US. Recognizing the challenge, some — but not all — EU regulators have stated that they will take a measured approach to early enforcement, so long as the industry maintains focus and urgency.

However, for measures already on the books, enforcement will continue to be strict, and punishment for breaches harsh. Consequently, investors will reinforce supervisory pressure on banks to improve their conduct in both wholesale and retail markets. Given the ongoing threat of terrorism and the prevalence of financial crime, the focus on know-your-customer (KYC) and anti-money laundering (AML) rules will continue. This will be reinforced by reviews of cybersecurity, especially in light of recent revelations that systems are more vulnerable than previously thought.

In addition, supervisors will continue to exert pressure on banks to put in place controls to ensure that each and every transaction is not only permissible for the bank, suitable for the client and authorized for the trader but also compliant with rules against improper trading. In this respect, banks can expect the authorities to continue to support the adoption of quasi-voluntary codes such as the Fixed Income, Currencies and Commodities (FICC) Market Standards Board code and the FX Global Code of Conduct.

In the retail area, supervisors will further step up their efforts to ensure that banks are treating their customers fairly. They will aim to identify and proactively address areas where market practice or developments may cause harm to consumers, especially vulnerable customers. This will stretch across the product cycle, from new product development to product performance and complaint handling, and across all aspects of financial services, including banking, mortgages, investment platforms, asset management and insurance.

The challenge from new entrants

Additional pressure on banks is likely to come as regulators reset rules in response to new technology. Governments are now actively promoting the entry of technology-based firms (FinTech) as a means to disrupt traditional banking and introduce more competition into banking services. To help new entrants launch their services, a number of supervisory authorities have created so-called "regulatory sandboxes" in which a firm may "play" or experiment with approaches to find a business model that is both profitable and compliant with regulation.

"Open banking" takes this approach one step further. Under the EU's Second Payment Services Directive (PSD2), banks have to make available to third-party providers any data pertaining to the customer that the customer authorizes the bank to disclose. A separate measure, the General Data Protection Regulation (GDPR), requires firms in the EU, as well as firms in third countries dealing with EU persons, to assemble the data pertaining to each person. Together, these measures facilitate the ability of FinTech firms to acquire customers and grow their businesses quickly. But some important issues remain to be clarified, above all the division of responsibility between the FinTech provider and the bank, and the degree to which the FinTech provider can rely on the bank's procedures to vet its customers under know-your-customer (KYC) and screen transactions under anti-money laundering (AML) rules. Banks face the danger that the customer relationship (and revenues) will migrate toward the FinTech provider, while much of the risk would remain with the bank.

However, the ultimate disruptor of traditional banking may not be FinTechs, but a central bank digital currency (CBDC). If issued, a CBDC would not only replace cash, but displace deposits and possibly money market mutual funds. Today, technical, security, privacy and macroeconomic policy issues have led central banks, when asked about CBDC, to respond, "not now." That's a far cry from "never," and central banks continue to work toward overcoming the obstacles to introducing a CBDC, so as to expand their policy tool kit.

Although the challenge from central banks may be far off, the challenge from the new technology is not. Big data, advanced analytics and robotics together hold the promise to reduce costs, improve risk management and build revenues. The firms that translate that promise into reality — be they new entrants or existing players — will win market share at the expense of those who will not or cannot.

Don't let a good recovery go to waste

As 2018 begins, the immediate outlook for banks is favorable: economic growth is picking up and interest rates are projected to rise while corporate tax rates in the US, the UK and possibly other jurisdictions will decline. And, as banks continue to whittle down the legacy list of crisis-related compliance cases, they may be able to reduce the amount they have to put aside for fines and settlements.

But these favorable conditions are unlikely to last. At some point, the economic cycle will turn down again. Sooner, rather than later, technology will disrupt banking and finance, just as it has disrupted other industries and markets. And, the penalties for failure are likely to be swifter and harsher: thanks to resolution reform, investors, not taxpayers, will bear the cost of bank failures. The rule is likely to be bail-in, not bailout.

Consequently, investors, like supervisors, will ask whether the bank has a business model that is strong enough — both in concept and execution — to survive not only a possible downturn, but the disruption that will ripple across the industry, as the new technology takes hold. The board therefore needs to ask whether the bank has a game plan or strategy that will enable it to pay investors an adequate rate of return over time. If not, does it still make sense for the bank to stay and play? Or should the board be looking to sell or merge the bank, lest the bank at some point require resolution and the authorities simply take the bank away?

For those banks that decide to stay and play, it will be tougher to win. At a minimum, banks will need:

1. *Good governance*. Both supervisors and investors will look to banks to develop and implement a robust risk appetite framework. This should include not only a risk appetite statement, but also the policies and procedures that will ensure that the bank has the financial, technical and managerial capacity to assume the risks its strategy calls upon the bank to take as well as a mechanism to ensure that risk remains within risk appetite and risk capacity, not only at the group level but also within each jurisdiction and each legal entity in the group.

   The key to good governance — as called for under senior manager regimes in major jurisdictions — is allocating responsibility for specific functions to senior executives and members of the board and holding those individuals accountable for meeting those responsibilities. In particular, business executives (the so-called first line of defense) should be responsible for assuming risk as well as driving revenues, while risk management and compliance (the second line of defense) and internal audit (the third line of defense) should exercise control.

2. *A culture of compliance*. Banking ultimately relies on trust, and banks still have some way to go to repair the damage to their reputation caused by their past misconduct. Banks recognize this, and most have made major investments over recent years to strengthen compliance capabilities and build more robust regulatory compliance risk management methodologies. Both prudential and conduct supervisors will assess whether the investments have changed reality. If they have not, banks can expect add-ons to Pillar 2 capital to offset potential breaches as well as hefty fines and settlements for any actual breaches.

   Banks' efforts to improve compliance need to continue. In particular, banks need to explore how the new technology can promote better compliance. Advances in data management, analytics and robotics make more comprehensive and continuous monitoring possible. This, in turn, enables banks not only to detect breaches more quickly, but also to identify (and therefore mitigate) factors that could lead to breaches in the future.

3. *Command over data*. Data is the bedrock for banking: for identifying clients, accounts, balances, transactions, risks, assets, liabilities, income, etc. The data needs to be accurate, accessible, consistent, secure and up-to-date, in line with the Basel Committee's standards on risk aggregation and risk reporting. The transformation of products and services onto a digital basis represents an opportunity for banks to improve data management as well — and a risk, if they do not, that data will be duplicated, defective and/or delayed.

4. *Ability to analyze*. As regulation fragments finance, as the recovery ages and as new entrants target banks' most profitable activities, the ability to analyze across multiple dimensions becomes more important. Indeed, if banks are to be able to monitor, model and manage risk and finance from a business, product, legal vehicle and group perspective to the standard that supervisors demand and investors expect, they will have to improve data management, adopt advanced analytics and employ robotics.

5. *Proficiency in partnering*. No bank can do everything it needs to do on its own, at least not with the speed or sophistication needed to keep pace with competitors in a rapidly changing environment. If a bank is to build, or even just defend, its business, it has to insource capabilities from and/or outsource functions to external providers. This can take many forms (service agreements, licensing, joint ventures, acquisitions, etc.) and is subject to extensive regulation. Banks need not only be able to identify the opportunity and do the deal, they also need to ensure that the deal delivers.

   An area of great potential is the creation of new infrastructures or platforms that can take on reference and review functions. Rather than have hundreds or even thousands of banks each do a cursory job of checking a prospective customer or supplier, a central platform/utility could perform that function for all in greater depth and at lower cost, issuing reports to participating banks and/or digital passports to the customer or supplier.

All this will be required to stay in the race. To win, a bank will have to anticipate and meet customer needs while generating returns that meet investor expectations.

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EY Global Regulatory Network Executive Team Previous appointments

Mario Delgado: FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy: Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF.

Marie-Hélène Fortésa: Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank.

Eugène Goyne: He has over 20 years in government and senior regulatory roles. He was previously deputy head of enforcement at the Hong Kong Securities and Futures Commission (SFC). Prior to the SFC, Eugène worked at the Australian Securities and Investments Commission and the Australian Attorney General's Department.

Dr. Tom Huertas: UK Financial Services Authority's Executive Committee; Alternate Chair of the European Banking Authority, Basel Committee on Banking Supervision; and Financial Stability Board Resolution Steering Committee.

Kentaro Kobayashi spent 37 years as a financial regulator. He held positions in the National Tax Agency and later, Ministry of Finance (MOF), Japan's former financial regulator. After the establishment of the Financial Supervisory Agency (FSA) of Japan in 1998, he served as Chief Inspector and Inspection Administrator and continued to serve in this role after the FSA was reorganized into the Japan Financial Services Agency in 2000.

Christian Lajoie: As former head of Group Prudential Affairs, BNP Paribas, Christian has broad banking experience and a deep understanding of the regulatory and supervisory impacts on bank management and strategy. He played an active role in regulation-making, participating in many international fora and also served as vice-Chair of the EBA Stakeholder Group.

John Liver: Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision, and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and its predecessors. Current EY/UK Financial Conduct Authority relationship lead.

Shane O'Neill: He has 20 years' experience in banking, capital markets, asset finance and prudential regulation in a variety of CFO, COO, Strategy & Planning, and Regulatory roles. Following the financial crisis, Shane was Head of Banking Supervision at a Eurozone Central Bank for four years, during which he influenced significant restructuring, recapitalization and change in the banking sector and in credit institutions, and executed numerous stress tests and asset quality reviews.

Keith Pogson: Immediate Past President of the Hong Kong Institute of Certified Public Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities.

Marc Saidenberg: Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning.

Scott Waterhouse was capital markets lead expert for large banks at the Office of the Comptroller of the Currency (OCC) and Examiner-in-Charge of the OCC's London Office. He coordinated the supervision of trading, treasury and capital markets activities including Dodd-Frank implementation and Basel Committee requirements.

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Our Global Regulatory Network helps clients find solutions to their regulatory challenges, providing extensive experience, leadership and strategic insights on financial regulation. The network helps our clients to understand and adapt to the impact of the changing regulatory landscape.

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 helps 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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