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FINANCIAL SERVICES

Evolving Banking Regulation
EMA Edition

The journey continues – the clock is ticking…
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About this report

This report is part of a regional series developed by KPMG's network of regulatory experts. The insights are based on discussion with our firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region.

For other regional reports, please contact fsregulation@kpmg.co.uk or see www.kpmg.com/regulatorychallenges

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Foreword

Welcome to this year's *Evolving Banking Regulation* for the Europe, Middle East and Africa region. In previous years, we provided a global overview of regulatory reforms and their impacts on the banking sector. The pace of regulatory change and implementation now varies significantly across the key regions of EMA, ASPAC and the Americas, bringing with it unique challenges. This year's regional editions highlight these challenges, alongside a snapshot of global regulatory activity and what it means for banking, in 2013 and beyond.

Jeremy Anderson, CBE
Chairman, Global Financial Services

As we look forward to the year ahead, the global financial system remains fragile and unstable. Meanwhile, the regulatory reform agenda continues to look far from a finished product, five and a half years after the financial crisis began in the summer of 2007.

Regulatory reform was intended to make financial institutions and markets more transparent, less complex and less leveraged. But progress has been limited because many of the reforms are still in the early stages of implementation, other reforms remain on the drawing board, and crisis intervention measures are still in place in many countries. As the IMF remarked in its Global Financial Stability Report of October 2012[1], "although there has been some progress over the past five years, financial systems have not come much closer to those desirable features."

In last year's report, we focused on two main areas: the prospective impact of the Basel 3 package of regulatory reforms across regions and countries, and the development of a 'second wave' of regulatory reforms, focused primarily on addressing the systemic risks inherent in the structure of the financial system itself and the systemically important banks within it.

This year, we highlight the strategic and operational challenges that the waves of regulatory reform will pose for banks in Europe in 2013 and beyond. We also present a snapshot of how the regulatory measures implemented in the Americas and Asia-Pacific regions will affect major European banks with significant operations in those regions.

As I discuss these regulatory reforms with the senior management of banks, I am struck by the magnitude of the challenges they face. First, banks are being pulled in many directions at once. The regulators want banks to be prudent. Customers want lower banking costs. Banks' creditors want to make sure they get their money back. Shareholders want them to be profitable. There inevitably have to be trade-offs here, and striking the right balance is proving difficult for both the banks and their regulators.

Second, banks face a wide range of regulatory reforms – both individually and collectively. There is then the even more important challenge of deciding what these regulatory reforms – together with all the other drivers of the business – mean for each bank's strategy and business model; and implementing effectively the necessary changes.

Senior management are having to focus simultaneously on two very different aspects of their businesses. One is the internal re-engineering of corporate and risk governance, and making crucial changes to the roles of Risk and Compliance functions. The other is a response to external pressures, from the market and regulators, to restructure, alter the mix of business activities and innovate in order to reduce costs and raise revenue during a period of economic stagnation in Europe and slow growth in the rest of the world.

We are also seeing that those banks that undertake the fastest, smartest transformation are most likely to succeed. Timidity in the face of turmoil is unlikely to win the day. My over-riding sense, as I review the new financial regulations at various stages of implementation and the uncertain economic climate, is that simplicity is the best rule to follow. Given a choice for banks between two paths – whether they are strategies, processes, structures or services – the simpler one is likely to prove more successful.

So what do we see as the future of banking in the EMA region? Europe's banking industry is likely to see significant consolidation – and to remain highly

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concentrated – despite the increased regulatory and supervisory pressures on systemically important banks. The second tier is likely to shrink in both breadth and number. Many will focus on their home turf and – apart from the biggest institutions – venture less outside their home country and region. Banks should also be designing their operations so they are sustainable at a lower return on equity than during the boom years. We are likely to see the same brand names in the market, but with fewer opportunities for challenger banks in the marketplace. There may, however, be a more competitive challenge from 'shadow banks'.

This is a difficult and complicated journey – and it is not yet clear where the road will lead. But now is a good time to start building the new era of banking.

The future of banking

Five to seven years on, we are likely to see four common themes in the banking world.

- **Restructuring** in favour of robustly capitalized, locally funded, client driven businesses centered around regional hubs.
- **A real client focus at the heart of the organization** will make firms more agile.
- **The right culture and people** will engender trust and enable banks to successfully execute business.
- **Good relationships with regulators**, built on trust from regulators, investors and the public, will provide sufficient freedom for banks to operate.

Banks are taking steps to secure their place in the new world order. There are a number of actions that can and should be taken now. Banks should:

- **Re-examine the purpose of each of their businesses.** There has never been a better time to re-examine every assumption underpinning the business. Now is the time to take a step back and ask: "Why are we doing this?" and "Are we doing this the right way?".
- **Be bold.** Banks who recognize early on the need to transform rather than tinker will position themselves for advantage.
- **Focus on core activities** – be it in terms of profitability or reputational risk – and rebuild or create ones that do. Governance, structures, processes, controls and reporting now require the intense focus that building revenues had in the past.
- **Simplify the structure.** Review and rationalize entity and operating structures to ensure they are fit for purpose – both for banks and their supervisors.
- **Invest in people and infrastructure** to deliver better customer and business outcomes.
- **Actively engage in the policy process**, providing much-needed industry perspective and insights.
- **Build trusting relationships with regulators, investors and the public.** This will require the banks themselves to create a culture of integrity. Trust cannot be regulated into existence.
- **Define new ways to motivate employees**, as it will be an increasing challenge to retain and incentivize skilled staff, in the face of the intense scrutiny from regulators and the public.

1. *Global Financial Stability Report*, IMF, October 2012.

Executive Summary

The strategic and operational challenges facing European banks have never been greater.

The regulatory reform agenda is perhaps the biggest driver of strategic and operational change – managing this is a key challenge for the industry. Banks have to contend with a multitude of new rules – global, regional and national – with each jurisdiction moving at its own pace and applying its own interpretation to commonly agreed high level principles. The momentum for regulatory reform has also been reinforced by the political and populist responses to the financial crisis.

As a result, banks have to respond to a wide spectrum of regulatory initiatives, from capital and liquidity requirements to corporate governance, from derivatives to the design of retail products, and from resolution to remuneration. The interfaces between these various initiatives make it crucial for banks to consider and respond to their collective impact, not just implement each one separately.

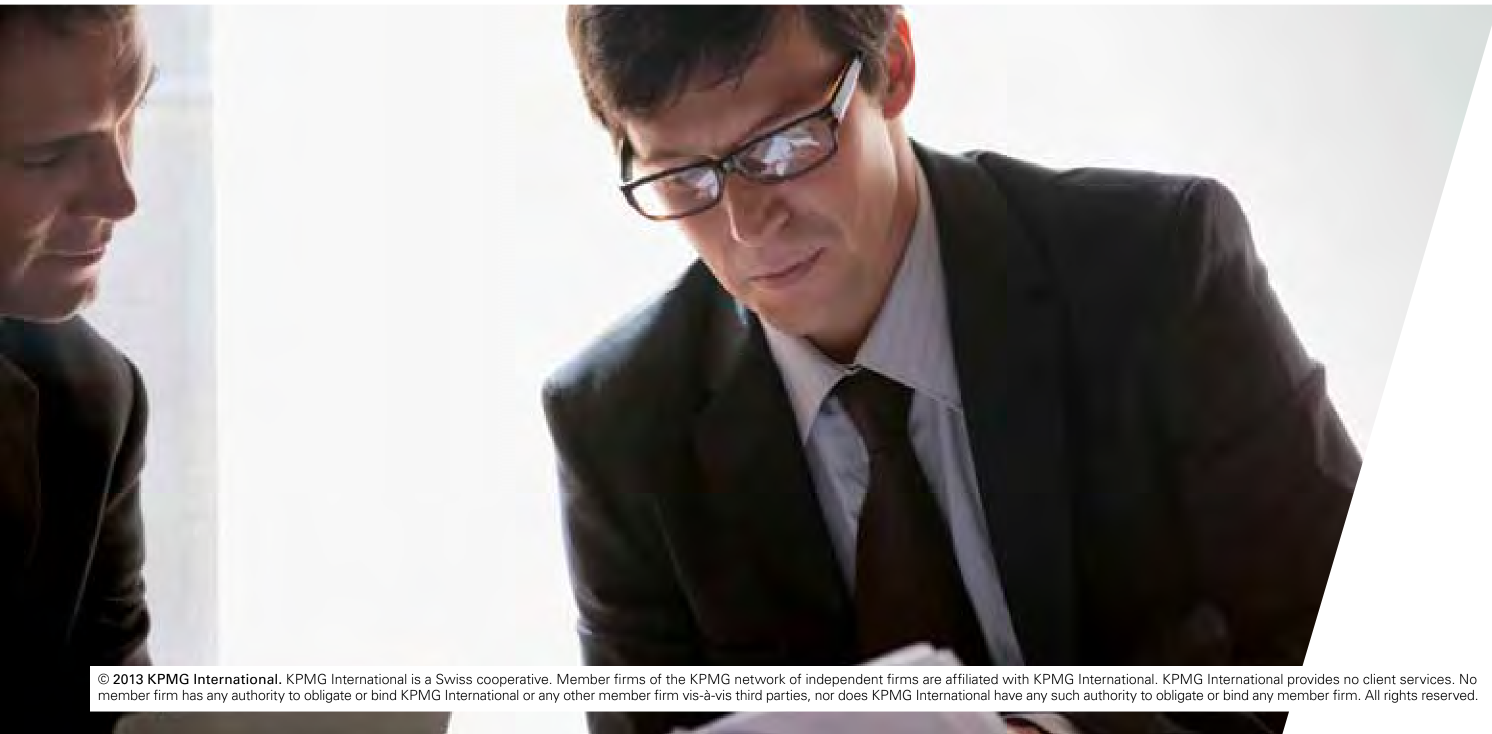
Banks are also struggling to restore public trust and confidence, much of which was wrecked by the financial crisis and successive scandals, from the mis-selling of retail financial products to the manipulation of LIBOR.

While policymakers continue to influence the shape of banking through new regulation, the second major driver of change is responding to economic conditions and competitive forces that are driving yet more upheaval for the sector and its players. Europe, in particular, remains in a state of flux. As a result of these drivers, banks are in the midst of a multi-year transition and will emerge from it in a very different shape than when they went in.

Grasping the opportunities from this challenging environment is easier said than done. Navigating the regulatory maze requires great concentration and attention to detail – and this is far more than just a compliance exercise.

This report aims to provide a guide through the maze. We consider the strategic and operational challenges banks face as they re-assess their business models. Every activity and process needs to be re-evaluated. In our view, the future of banking will see a return to the old-fashioned virtues of trust and relationship-building, but it will be combined with new technologies that enable financial institutions to deliver the highest-quality customer service at a lower cost than before.

We then provide an update on the regulatory landscape, from measures to deal with capital adequacy; systemic risk; resolution planning; and shadow banking. In addition, increasing emphasis is being placed on new and upcoming rules to protect consumers, a focus that can be seen not just in new consumer regulations but in fines and other measures designed to change corporate cultures.



Key challenges

- **Regulatory complexity and uncertainty.** There are multiple new regulations for banks to contend with, in various stages of development and implementation. Even the regulators are now worried about the volume of regulation.
- **Diminished returns.** At a time when revenues are under severe pressure, bank costs are rising as a result of regulatory initiatives.
- **Aligning strategic and business model choices to the new environment.** The combination of regulatory reform and economic weakness and uncertainty may not make the choice of strategic direction any easier for banks, but it certainly makes it imperative for banks to take key decisions about their futures.
- **Big data, little use.** The reporting requirements to comply with new regulations have grown so rapidly that banks are left wondering what the information will be used for. Banks are drowning in data, and not themselves using it very effectively.
- **Culture.** Banks have to change their culture and behaviors – but this cannot be achieved simply through new procedures. It requires banks to take difficult decisions, and then to implement them effectively, working to restore trust and rebuild customer confidence.

Opportunities

- **Client relationships are crucial to success.** Banks that have retained a genuine customer focus have fared better than their competitors. There is nostalgic talk of 'going back to basics' and simplicity will certainly be increasingly important, but a return to traditional banking in 2013 is not an option. Consumer behavior and market characteristics have changed irrevocably over the last 30 years – and there is no turning back.
- **Technology.** The winners are likely to be those banks that use technology to build ever tighter relationships with their clients. There will be continued investment in the technology needed to provide clients with better service, with figures for retail banking IT spend predicted to reach US$135 billion over the next five years.[2] Banks are already looking at ways to digitize relationships with customers, utilizing user-friendly direct channels, such as mobile or internet banking, and modern user interfaces, such as social media.
- **Facilitating 'the real economy'.** Investment in customers and technology will provide a platform for services that fuel commerce and investment at an acceptable return.
- **A strong balance sheet** and global capital market coverage are determinants of success. Global financial markets will be dominated by a handful of very large banks – it will be difficult for the banks in the next tier below them to compete without a large balance sheet and a high level of expertise in each market.

2. *Retail Banking Technology Spending Through 2015*, Datamonitor/Ovum, 2012

Navigating the regulatory maze requires great concentration and attention to detail – and this is far more than just a compliance exercise.

Regulatory Pressure Index

The regulatory pressure index sets out an assessment of the scale of the challenge posed by key areas of financial sector reform throughout 2012 for three major regions – Europe, Middle East and Africa (EMA); the United States; and Asia-Pacific (ASPAC). This is based on discussions with clients in each of these regions, as well as on KPMG's assessments of key regulations and discussion papers. The table includes an assessment for 2010 and 2011 so that comparisons can be made on how pressures have changed.

Regulatory Pressure Index

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Capital **Objectives:** • Increase both the quantity and quality of capital buffers in order to reduce the possibility of bank failures **Policies:** • Basel 3 (Global) • CRR/ CRD 4 (Europe) • Dodd-Frank (US) • Capital Surcharges (FSB)	2010 2011 **2012**	4 5 **5**	4 4 **5**	2 3 **4**	• Basel 3 requirements continue to prove a considerable challenge for all banks globally, with many in the West struggling to raise capital in a time of deep uncertainty, and banks continuing to deleverage. The shortfall against Basel 3 requirements in Europe is significant. • In addition, the Basel Committee on Banking Supervision is also reviewing the trading book and model-based Risk Weighted Assets (RWAs). • In Asia, capital has become the current focus, as it is the aspect of Basel 3 with the most imminent implementation date of January 1, 2013, or soon thereafter. Although banks in Asia can generally meet the new requirements with little difficulty at present, there is an emerging concern that the requirements could potentially act as a constraint on balance sheet growth in the years ahead. • In the US, there is continuing regulatory scrutiny of capital quality and plans. Stress testing efforts remain an important element of these assessments, with 30 US institutions with over US$50 billion in consolidated assets subject to either the Comprehensive Capital Analysis and Review (CCAR) or the Capital Plan Review (CapPR). In addition, the proposed intermediary holding company construct for foreign banks in the US will require adherence to US capital requirements and has strategic implications.

Regulatory Pressure Index *continued*

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Liquidity **Objectives:** • Ensure that banks have enough liquid assets to meet a potential run on funds **Policies:** • Basel 3 (Global) • CRR (Europe)	2010	5	4	4	• Most banks identify liquidity/funding as the issue that is of greatest importance to them. The recent changes to the calculation of the liquidity coverage ratio (LCR) – by extending the range of assets qualifying as high quality liquid assets and lowering the assumed run-off rates of liabilities – may ease concerns somewhat. • At the same time, supervisors are struggling to determine how best to implement the new requirements in Asia, where funding markets may be less developed than in the other regions. This remains a difficult issue in Asia. • While the Federal Reserve is still expected to implement the LCR in the US, the scope and timing remains unclear. More broadly, liquidity risk assessments remain less robust than supervisory efforts around capital. As the regulators begin to analyze the significant data that is being captured from institutions through new reporting mechanisms, greater scrutiny and emphasis on liquidity is likely. In the interim, regulators continue to carefully review liquidity, with emphasis on interagency guidance issued in 2010, as well as a greater emphasis on horizontal (cross-institutional) examinations.
	2011	5	4	5	
	2012	**4**	**4**	**5**	
Reform: Systemic Risk **Objectives:** • Reduce risks to financial stability, from the structure of the financial services sector or the failure of a systemically important financial institution **Policies:** • Capital Surcharges (FSB) • Dodd-Frank (US) • Crisis Management Proposals (US, EU) • Structural Change (US, UK, Germany, France and possibly the EU) • Federal Reserve Bank (FRB) proposals (US)	2010	5	5	1	• Large global banks have to meet increased capital requirements, prepare RRPs and are subject to enhanced supervision. • Europe will be affected by a significant number of proposals: the UK's Independent Commission on Banking (ICB), the EU Liikanen proposals (and additional national measures, eg. France and Germany), particularly regarding separation. We also await the outcomes of the EU Recovery and Resolution Directive (RRD) and Banking Union. • We are not seeing a major push from supervisors in the Asia-Pacific region on systemic risk at present. Clearly, with further progress in the development of Recovery and Resolution Plans, this will change. • In the US, the Volcker Rule will affect firms across the globe, while the US has also proposed tougher treatment of foreign banks operating in the region. The FRB proposals on foreign banks, with a possible requirement for an intermediary holding company structure, is a significant shift from the virtual holding company structure and represents a material increase in regulatory requirements.
	2011	5	5	2	
	2012	**5**	**5**	**3**	
Reform: Supervision **Objectives:** • Ensure that banks are properly supervised, proportionately to the nature, size and complexity of their business **Policies:** • New supervisory structures, eg. in the US, UK, and Europe • More intrusive and challenging supervision • Dodd-Frank (US)	2010	4	5	2	• In Europe, the supervisory authorities (including the EBA) are playing a key role in developing a single rule book and a more consistent supervisory approach. Meanwhile, the European Central Bank (ECB) will begin to take responsibility for banking supervision in the eurozone from 2014. • The regulatory environment remains challenging for financial institutions in the US, as new requirements are being established and non-traditional institutions become subject to a more intensive and intrusive supervisory regime. Tolerance levels remain low and examiners are taking stronger actions, including enforcement actions, against a range of institutions. In addition, consumer protection issues remain a key area of emphasis as the Consumer Financial Protection Bureau (CFPB) continues to build out its program. • Supervisors in Asia are generally comfortable that they have appropriate structure and powers, and it seems unlikely we will see a major shift in supervisory approach or focus. However, supervisors will have to consider imminently whether changes are required in the supervision of (domestic) systemically important banks.
	2011	5	5	3	
	2012	**4**	**4**	**2**	

Key: **5** = significant pressure **3** = moderate pressure **1** = low pressure

Regulatory Pressure Index *continued*

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Governance **Objectives:** • Ensure that Boards have sufficient skills, experience and availability to assume full accountability for the decisions taken by the organization **Policies:** • CRD 4 (Europe) • MiFID 2 (Europe) • EBA Governance Guidelines (Europe)	2010 2011 **2012**	4 4 **4**	4 4 **5**	4 4 **3**	• In Europe, banks will need to meet the corporate governance requirements in CRD 4 and the Markets in Financial Instruments Directive (MiFID 2), while systemically important banks will be subject to the Financial Stability Board's (FSB) conclusions on risk governance and the Basel Committee's Principles on risk data aggregation and reporting. The FSB review of risk governance will maintain – and in some cases increase – the pressure on banks to improve their governance. • The rulemaking around governance requirements in Dodd-Frank suggests that requirements are being tightened even further. For example, regulators in the US are looking to significantly increase the expectations around directors' knowledge and prior experience with risk management issues. In addition, other governance changes suggest a potential blurring of the line between oversight and direct management of an institution. While the emerging standards apply in particular to directors on the risk committee, there is the risk that examiners will apply similar expectations to other directors, with potential consequences for the composition of boards. • While enhancing governance and Board oversight remains an important policy objective in Asia, we have not seen many supervisors prioritizing this at present. This likely reflects that supervisors in the region do not feel that the need for cultural change is as great in Asian institutions. The focus in Asia is generally more on risk management and oversight through implementation of Basel 2 advanced approaches.
Reform: Remuneration **Objectives:** • Regulate excessive remuneration practices **Policies:** • FSB principles on remuneration (Global) • Dodd-Frank (US)	2010 2011 **2012**	4 3 **4**	3 3 **3**	1 1 **1**	• In Europe, amendments to CRD 4 tabled by the European Parliament may result in limits on bonuses as a proportion of base salary. • In the US, regulators continue to expect enhancements to compensation processes, driven in part by the results of the 2011 horizontal examination report. • This is not attracting much attention in Asia, where excessive remuneration has not been an issue in local institutions.
Reform: Customer Treatment **Objectives:** • Protect the customer, help the customer make informed investment decisions and ensure that the products sold to the customer suit his/her investment profile **Policies:** • MiFID (Europe) • Dodd-Frank (US) • CASS Directive (Europe) • RDR (UK) • PRIPs (Europe)	2010 2011 **2012**	3 4 **4**	4 4 **4**	1 2 **2**	• In Europe, a flood of rules, including the review of MiFID 2; Packaged Retail Investment Products (PRIPS); the UK Retail Distribution Review (RDR); and new product intervention powers for the conduct-focused regulators are evolving to protect the customer. • In the US, regulators continue their focus on protecting the consumer as evidenced by recent CFPB enforcement actions. Recent focus has moved beyond the banks themselves to their vendors in order to determine their ability to manage compliance and consumer protection. • Although still not a major focus in Asia, we are starting to see more jurisdictions launch enhancement initiatives in this area, typically more in relation to investment products than general banking products. Given that this is a key focus of regulatory reform in the US and Europe, it is likely that we will see increased interest in this area in Asia.

Regulatory Reform, Policies and Objectives	Year	EMA	US	ASPAC	Impacts for Banks
Reform: Traded Markets **Objectives:** • Reduce risk in the wholesale markets and regulate the Over the Counter (OTC) derivatives market **Policies:** • Dodd-Frank (US) • MiFID (Europe) • EMIR (Europe) • G20 (Global)	2010 2011 **2012**	4 4 **4**	4 4 **4**	1 2 **3**	• There has been a lot of activity in traded markets regulation throughout 2012. The Dodd-Frank Act (DFA) in the US, the European Market Infrastructure Regulation (EMIR) and aspects of MiFID 2 in Europe all have an impact on the structure of wholesale markets and in particular how derivatives are traded, cleared, settled and reported. As these reforms move into the implementation phase, they pose significant challenges for all market participants. • Key ASPAC markets are beginning to formulate policies in response to the G20 agenda on derivatives.
Reform: Accounting and Disclosure **Objectives:** • Consider whether accounting policies need to be revised and the additional disclosures that may be required • Move to expected loss provisioning **Policies:** • IFRS 9 • CoREP • EDTF recommendations endorsed by the G20 and FSB • Financial Instruments and Leasing Convergence Projects	2010 2011 **2012**	3 3 **3**	3 3 **3**	3 3 **2**	• Still awaiting resolution of the debate on whether banks should move to an expected loss, rather than impairment, approach to provisioning. • The IASB and FASB have proposed new financial instrument impairment models that are likely to accelerate recognition of loan losses and reduce capital for accounting purposes. Although initially a joint proposal between the Boards, the FASB has recently proposed a separate current expected credit loss (CECL) model for upfront recognition of credit losses expected over the life of loans and investment securities. • Enhanced Disclosure Task Force (EDTF) recommendations on improving disclosure by banks, including the justification for internal model based risk weightings that are substantially below both industry averages and standardised risk weightings. • Disclosure requirements to reconcile the US GAAP and IFRS accounts may create an additional reporting burden. As Dodd-Frank is implemented, Title VII will have an impact on accounting for OTC derivatives. Companies will need to monitor carefully. • Not an area currently receiving a lot of attention in Asia. Several supervisors are focusing on provisioning and requiring banks to top up provisions above the level suggested by accounting requirements.
Reform: Financial Crime and Tax **Objectives:** • Prevent market abuse and financial crime • Ensure that investors comply with the relevant tax authorities • Use tax as a means of paying for some of the costs of the crisis **Policies:** • FATCA (US) • FTT (Europe) • MAD/MAR (Europe) • Anti-Money Laundering (AML)	2010 2011 **2012**	n/a 4 **3**	n/a 4 **4**	n/a 3 **4**	• Foreign Account Tax Compliance Act (FATCA) introduces a new withholding tax regime and will place a significant burden on many banks, affecting operations, IT, front office and a number of areas of their business. • As elsewhere, FATCA is a significant issue for firms in ASPAC, with notable challenges being the effective and timely development of compliant systems/data/policies. As institutions become aware of the complexities involved, this is now becoming more urgent. • In Europe, the LIBOR rate-fixing scandal has led to large fines. The Market Abuse Regulation (MAR) is being amended to outlaw manipulation of benchmarks such as LIBOR, boosting minimum fines for insider trading and proposing criminal sanctions on anybody found to have manipulated benchmarks. • The introduction of a Financial Transactions Tax (FTT) by 11 EU member states will have implications for European firms' compliance and will be a significant challenge and costly exercise for banks. • Another area of increasing focus is Anti-Money Laundering (AML) compliance and associated Know Your Customer (KYC) regulations.

Key: 5 = significant pressure 3 = moderate pressure 1 = low pressure

Challenging times

The banking industry is at a major inflection point – change is unavoidable. Banks face challenges from multiple sources, including the external macro-economic environment; their competitors and the emergence of new competitors; and the continuous struggle to increase efficiency, control costs and maintain margins. But the single most pervasive driver of change is the regulatory agenda.

The regulatory agenda

Five and a half years since the start of the financial crisis in the summer of 2007, the extensive 'more of everything' programme of regulatory reform is far from complete. Some elements (for example, Basel 3, OTC derivatives and key elements of the EU consumer agenda) are reasonably complete in their design and their transposition into EU legislation, but are yet to be implemented. Indeed, 2013 will be the first year of implementation for many of these initiatives.

Other elements (for example, recovery and resolution planning, the additional capital, governance and supervision requirements for systemically important banks, the review of capital requirements for banks' trading books, and eurozone banking union) are becoming increasingly clear as concepts, but details remain uncertain. Here, 2013 will be a year of developing the detail and turning this into specific requirements for banks.

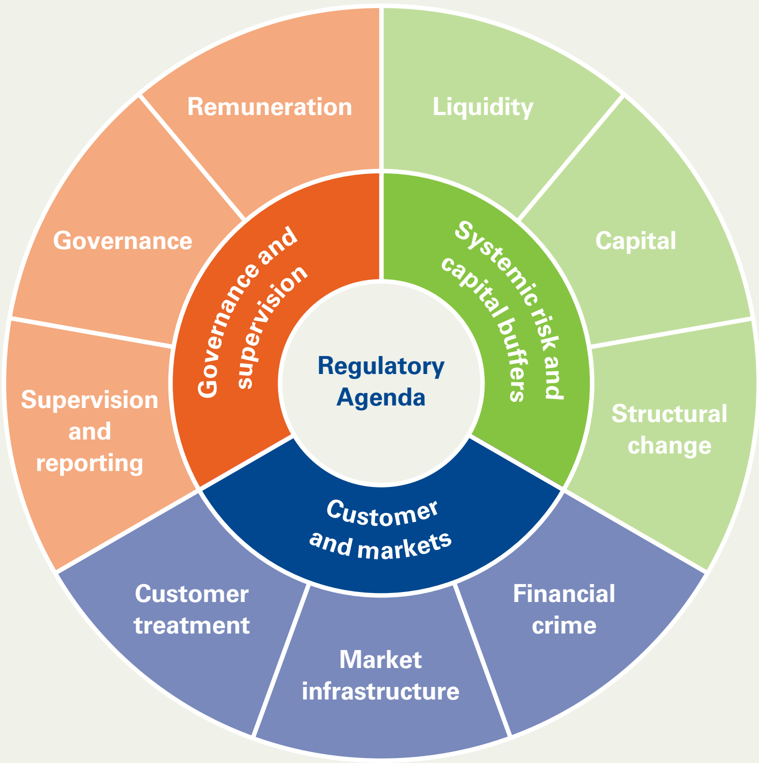
Finally, some elements (for example, shadow banking, the use of macro-prudential tools, and decisions on whether to apply the Liikanen report recommendations) remain on the drawing board. For these elements, 2013 will be a year of decision-taking, with implementation some years away.

Banks will therefore have to deal with a combination of implementing existing initiatives, awaiting the detail in areas where the direction of travel is clear, and dealing with new initiatives, where major decisions have not yet been taken. We discuss all of these elements in *The regulatory landscape* on page 32.

However, we first set out an overview of how banks are approaching this change journey and some of the key challenges they will be addressing along the way. The approach that many clients are taking to this challenging environment has been multi-faceted – and in some cases disjointed. Developing a comprehensive outlook across the regulatory landscape and an understanding of its overall impact on business is becoming critical. Dealing with issues on an individual basis is both ineffective and often misses the point. Nor is it sufficient for banks to focus only on regulations that are currently being implemented – banks must not take their eyes off the regulatory developments that lie ahead.

Understanding the regulatory agenda

The regulatory response to the financial crisis has taken the form of a series of initiatives focused on:



Systemic risk and capital buffers

Improve the safety and soundness of individual banks and thus reduce the likelihood of banks failing. This is through a combination of more robust financial resources and proposals to make banks easier to resolve – through either pre-emptive structural changes (eg. Liikanen proposals) or planning ahead in the event a bank runs into trouble (RRP).

Customer and markets

Change the structure and practice within both wholesale and retail financial markets to increase transparency, improve efficiency, and enhance the quality of customer outcomes by changing incentive structures and requiring a more diligent assessment of customer activities and needs.

Governance and supervision

Improve the people and infrastructure with which banks govern their business. This underpins the rest of the regulatory agenda. The composition, consistency and effectiveness of governance, risk and control frameworks must be re-visited to deliver a model which is fit for the future.

The number of individual policies facing banks seems endless. But the objectives of many are highly interdependent with other similar initiatives. Understanding this connectivity allows you to move from tackling each policy as it comes (Challenge 1 – see page 12) to a more thematic approach which supports more effective planning and change management (Challenges 2 and 3 – see page 12).

Developing a comprehensive outlook across the regulatory landscape and an understanding of its overall impact on business is becoming critical.

The journey from regulation to transformation

Institutions with sufficient resources and foresight are now progressing from reviewing regulation to designing the major transformation needed to position for success in the changing landscape.

Challenge 1

Responding to individual regulatory initiatives

- Compliance with detailed requirements.
- Meeting new and expanding reporting requirements.

This is necessary – any one regulation can cause banks to change their business models – but it is not sufficient to view regulatory reforms in isolation...

Challenge 2

Responding to the combined and cumulative impact of regulatory initiatives

- Regulations are not introduced in a vacuum.
- Identify and assess the inter-relationships between regulatory initiatives to support transformational change.

Challenge 3

Combining regulatory reform challenges with other challenges – shaping business models accordingly

- Develop business, structural and operating models in full compliance with the new and developing regulatory regime – while still attracting investors.
- Continue to improve efficiency while complying with new regulations.

Challenge 4

Restoring customer focus and trust by tackling the deep-seated issues of culture and behavior

- Change cultures and behaviors to meet customer expectations and regulatory requirements and deliver sustainable growth.
- Changing customer needs require innovation and investment – and new means of compliance.

Maturity of organizational response

Many banks in the region are shrinking the range of services they offer as they restructure their balance sheets, in particular by disposing of non-core assets.

Challenge 1

Responding to individual regulatory initiatives

The main focus for many of our clients continues to be around implementation of a handful of critical policy initiatives, as described below.

Capital

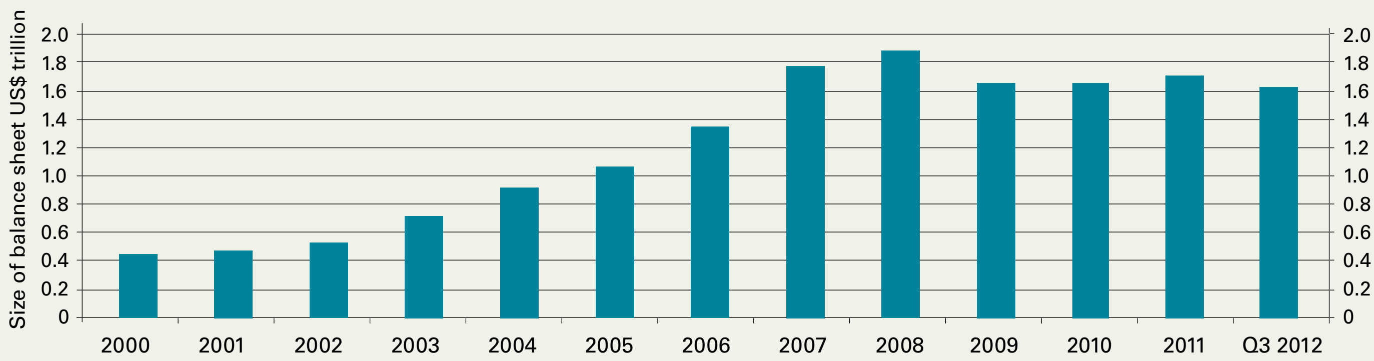
Banks are already monitoring closely where they stand against the Basel 3 minimum capital and leverage ratios – and taking action to meet them. Many banks have also been subject to pressure from the European Banking Authority (EBA) – through its stress tests based on a 9 percent core equity tier 1 capital ratio – national regulators and the markets to go beyond the Basel 3 minimum capital ratios, in terms of both amounts and the speed of implementation. For some banks, the remaining scale of adjustment may be relatively small, but the shortfalls have already forced many banks to re-assess their strategies and business models.

To comply with Basel 3 capital ratios, banks are:

- Raising new capital – some stronger banks have been able to issue new capital, while weaker banks in some European countries have received injections of capital from governments. Retained earnings have become an important source of capital, as banks cut back on dividend and bonus payments.
- Closing some business lines, selling assets and slowing the growth of new lending – the cost of new capital and declining rates of return on equity have forced banks to restructure and slim their balance sheets as a means of driving up capital ratios. But as the chart below shows, balance sheets of the largest banks remain far in excess of their pre-bubble average.
- Optimizing the calculation of risk-weighted assets – banks using internal models to calculate capital requirements can drive down their capital requirements by enhancing their data, models, systems and processes. For example, more complete data sets, an improved recognition of netting and collateral, and more refined allocation of exposures to internal rating grades can generate lower capital requirements. But increasing scrutiny from policymakers and supervisors is likely to limit the benefits here.

Retrenchment is the order of the day. Many banks in the EMA region are shrinking the range of services they offer as they restructure their balance sheets, in particular by disposing of non-core assets. Banks are focusing on core banking services, with a clear focus on retail, wealth management and corporate business, and on re-pricing these activities in an attempt to generate an acceptable rate of return on equity and on assets.

European G-SIFIs – average balance sheet size, 2000–2012



Source: Capital IQ, 2012

Liquidity

Meeting the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) will remain a major challenge for many banks, even after the revisions to the LCR announced recently by the Basel Committee on Banking Supervision (see details on page 33).To meet even the revised LCR, many banks will need to make expensive changes to their balance sheets – by holding larger amounts of low-yielding assets that are counted as high quality liquid assets in the calculation of the LCR, replacing short-term wholesale deposits with retail and longer-term wholesale deposits, and reducing committed facilities.[3]

Banks also need to consider their continuing ability to meet the LCR under the prospective conditions of stronger balance sheet growth, a reduction in the volume of government bond issuance and the reduction of central bank provision of liquidity.

As with the LCR, the NSFR penalizes short-term wholesale liabilities and encourages banks to increase their funding through retail deposits, longer-term wholesale liabilities and capital instruments. In addition, on the asset side of their balance sheets, banks may need to reduce their long-term lending through the sale of assets and a shift in the types of lending that they undertake to ease funding requirements.

However, there are limits on the extent to which banks collectively can attract more retail deposits, since the total sum of available deposits tends to grow slowly, and other banks will be chasing after the same depositors, thereby pushing up the interest rates paid on them and making retail deposits less stable as a source of funding. In short, banks' funding costs are likely to go up and the yield on high-quality liquid assets to go down.

Four other challenges on liquidity for banks are:

- The (re)pricing of both assets and liabilities to reflect the true cost of funding;
- The external and internal reporting requirements – and the systems and controls required to support them – for the monitoring of banks' positions against these new liquidity ratios, including the importance of assessing the potential impact of various stress tests and alternative scenarios;
- As with capital, the increasing 'localization' of financial markets, making it more difficult to conduct global, intra-group funding operations because national regulators do not want liquidity to flow across borders. However, at least in the eurozone, the creation of a banking union under a legal framework may make it easier for banks to conduct intra-group treasury operations across the eurozone; and
- Additional regulatory initiatives that will have an impact on funding and liquidity. For example, there are a number of policy proposals on the agenda of the FSB and the EU to take regulatory action around repurchase agreements (repos), ranging from additional reporting for banks to mandatory haircuts on repos. Such proposals could have a significant impact on the wholesale funding market.

Recovery and resolution planning and bail-in liabilities

The draft Recovery and Resolution Directive (RRD) has already acted as a 'wake-up call' to banks in many European countries who had previously made only limited progress on resolution planning. The EBA's recent announcement requiring plans from Europe's 39 largest cross-border banks in advance of the final

Banks will have to adjust to differences between their evolving national regimes and the final version of the Recovery and Resolution Directive (RRD).

3. See *Liquidity – A bigger challenge than capital*, KPMG, May 2012

RRD will accelerate the effort needed. The implementation of the requirements will generate major challenges for banks, in terms of both their legal and operational structures and the costs of recovery planning and bail-in liabilities. Banks will need to:

- Develop recovery plans based on severe stresses and scenarios, with prospective actions linked to specific triggers;
- Develop resolution packs to enable national authorities to take a view on whether effective and credible resolution plans can be constructed – banks will have to provide extensive information to their national resolution authorities;
- Make whatever changes are required by the authorities to improve the credibility and effectiveness of recovery and resolution planning, including higher amounts of contingent capital and funding to underpin recovery, and changes to business activities and legal entity and operational structures to facilitate resolution; and
- Hold whatever amounts and types of bail-in liabilities are required by national authorities. Such liabilities are likely to be expensive for banks, because unsecured and uninsured creditors will demand a higher return to reflect the removal of implicit state support.

Where more progress has been made, such as in the UK and the Netherlands, banks will have to adjust to differences between their evolving national regimes and the final version of the RRD. Smaller banks will need to discuss with their national authorities what relief they might obtain from these requirements, depending on the nature, size, complexity and systemic risk of their business.

Internationally active firms will have a particular interest in any lack of consistency in national standards, and in cross-border resolution arrangements – both within the EU and globally. Such firms will face major challenges in responding to any divergences in requirements across countries, and any lack of cooperation and consistency in their application. Actions required by one regulator to bolster the stability of economic functions in their jurisdiction could conflict with business or regulatory priorities elsewhere. In the long run, these tensions may produce a more localized operational structure for the largest banks.

Even within the European Union, national authorities may take different approaches in areas such as the stresses and scenarios that a recovery plan should cover; the extent to which national authorities require banks to make their recovery plans more robust; the detailed information to be provided within resolution packs; the financial and economic functions that are regarded as being critical; the extent to which national authorities require banks to change their business activities and their legal and operational structures in advance to reduce the cost and complexity of resolution; and the use of resolution tools and powers by national authorities. These potential inconsistencies are in addition to the existing differences in insolvency law across jurisdictions.

Banks also face a period of continuing uncertainty before the RRD and the resolution powers of the authorities are finalized – and probably for even longer before effective cross-border resolution measures are introduced.

Structural separation

The various proposals for structural separation – the Liikanen recommendations in the European Union, and national initiatives in the US, UK, Germany and France – pose a number of key challenges for banks.

There is continuing uncertainty about where these proposals will end up. In the European Union, the main issue is whether and how the Liikanen recommendations will be taken forward, while for the national initiatives a number of important details remain to be resolved – not least in the definition of exactly which activities will be prohibited, limited or ring-fenced.

For some banks, there will be issues concerning the combined impact of multiple requirements.

Where banks are caught by one or more of these proposals, another challenge will be to assess how ring-fencing will apply to them, and the implications of this for the legal entity and operational structure of their groups, both within and outside the EU.

These measures are likely to increase costs. Ring-fencing will increase the overall capital that a banking group needs to hold, and it will increase the cost of funding – especially if different parts of the group receive different external credit ratings, as retail deposits cannot be used to fund trading activities, and separation strengthens the perception of creditors that some parts of banking groups are less likely to receive government support.

It will also be expensive to collect and monitor the data and information required to operate the ring-fence and to establish, operate and monitor the independence and separation of ring-fenced banks.

Banks may also find it challenging to service large corporates across multiple entities, where these corporates place deposits in, and borrow from, a ring-fenced bank but also require products and services that a ring-fenced bank is not allowed to provide. Assessing the commercial viability of current business activities will be a key task.

A final concern is whether banking groups can demonstrate that groups combining retail and investment banking can generate sufficient synergies and rates of return to justify their continued existence, while meeting the proposals for structural separation.

Only the largest, most complex banks are likely to face significant direct impacts from these requirements. However, the scale of change for these organizations – which together dominate the financial sector landscape – will inevitably have major implications for the operation of the market as a whole, and for the availability and price of key banking services.
The regulatory uncertainty is seen as a drag on the share price, therefore hampering banks' long-term capital planning. As a result, some banks are not waiting for the regulations to be finalized – they are looking at ring-fencing key businesses long before the various official proposals are implemented, as well as subsidiarizing their operations. They are transforming their business models by decentralizing operations, cutting costs and making processes more efficient.

Market infrastructure change

The structure and operation of financial markets are subject to significant changes, driving major upheaval not only for banks but also the other financial and non-financial counterparties with whom they engage.

One of the most significant, and imminent, changes is the requirement for standardization and central clearing of over the counter (OTC) derivatives (transactions negotiated bilaterally between two parties with customized terms, rather than on an exchange). The single biggest challenge for all parties involved is the uncertainty around how closely aligned the national rules will

Market infrastructure change – key dates

By early 2013:

Dodd-Frank – firms need to be prepared to deliver against requirements as a foreign Swap Dealer or Swaps Participant, where applicable. Firms need to have determined which regulatory requirements are relevant to their business and the impact they may have.

EMIR – firms need to be in a position to begin delivering against a phased implementation plan which commences with the final publication of EMIR, currently expected in Q1 2013.

MiFID – firms need to be actively reviewing policy developments and considering the implications for implementation plans against other related initiatives.

eventually be across key markets, and the extent to which home country supervisors of parent banks will be prepared to accept compliance with host country rules by foreign subsidiaries.

The central clearing of derivative transactions will require processes and systems capable of identifying when a particular asset, in a particular jurisdiction and with a particular counterparty, is subject to clearing. In Europe, the definition of the venue on which cleared trades must be executed is still pending in the review of MiFID, and may take months (or years) to be finalized.

The buy-side

The effects of market infrastructure reforms will be felt not just by the 'sell side' parties offering derivatives as a service for risk mitigation. The 'buy-side' firms – who use derivatives to manage their commercial financial risks – are also swept up by the rules. Most other financial services firms are subject to the clearing requirement.

Non-financial firms are exempt – to the extent that they can continuously demonstrate the trades are undertaken to hedge commercial risks, or otherwise fall below the regulatory threshold. Even so, non-financial users will see the price of risk mitigation increase as banks pass on higher operating and financial costs associated with both cleared and non cleared derivatives. They also face choices around how they would like their collateral treated, which asset is most cost effective for their purposes, where they would like to trade and who with – as relevant rules could be different depending on any of these variables. They need robust reporting systems which can demonstrate whether or not their trading activity is eligible for exemptions. They also retain accountability for fulfilling new reporting and possibly risk mitigation requirements (confirmation, reconciliation), even where these are in practice outsourced to counterparties or other market infrastructures. Significant investment in systems and supporting compliance capability is therefore needed, on top of higher fees and prices.

The effects of market infrastructure reforms will be felt not just by the 'sell side' parties offering derivatives as a service for risk mitigation. The 'buy-side' firms – who use derivatives to manage their commercial financial risks – are also swept up by the rules.

Many of our clients are currently working through changes to data and trading systems to identify changes needed and gaps which will require new information. Operational infrastructure must be extended to ensure connectivity to key market infrastructures. But this is complicated, as none of these infrastructures are yet authorised under EMIR, technical specifications are yet to be issued, and multiple relationships may be needed to cover all asset classes and geographies. Business and financial models must be re-configured to reflect new costs, fees, pricing and capital considerations.

All market participants have expressed concern over the detailed rules emerging around the amount and treatment of collateral to support both centrally cleared and remaining OTC trades. Many of our clients have initiated significant change programs to help them identify more accurately where eligible collateral instruments sit within their organizations and how this collateral is being used.

The more advanced banks are looking at how they can improve or develop systems which allow them to optimize use of these instruments on a real time basis, often on behalf of clients. These activities are already coming under scrutiny from policymakers. Doing so requires significant data on what collateral is acceptable – at what price – by which counterparty, and whether collateral could be deployed more profitably elsewhere.

In principle, clearing and collateral transfer will be exempt for intra-group trades under EMIR. In practice, the criteria required to gain an exemption may not be met by all affiliates, increasing the cost and complexity of intra-group funding and risk management.

A second challenge for the management of collateral is that many assets which might be used as collateral under current regulations will be 'locked up' under new rules which allow banking clients to opt for their assets to be kept separately and not re-used (individual segregation). Banks will need to introduce enhanced processes and governance frameworks to cope with the possibility of a dramatic increase in the number of client money accounts. Some brokerage businesses will struggle to source funding without the ability to make use of client collateral.

Enhanced reporting requirements pose a major challenge for both buy and sell side market participants. The scope of new reporting will eventually be amplified by new requirements to extend pre-and post-trade information to new asset classes including OTC derivatives, under proposals in the review of MiFID. New data requirements, including collateral information and daily mark to market reporting as well as extended counterparty data, are proving difficult to source quickly and reliably. Finally, where trades cross borders in any way it remains unclear which trades will be subject to reporting in which jurisdictions and how these requirements can be fulfilled.

Larger banks have already begun the journey of implementing the necessary change to fulfil clearing requirements; many smaller banks still have a long way to go. Only the largest participants are likely to find that the return on equity for a broad base of business exceeds the combined costs of funding, capital and extensive operational and compliance requirements. Smaller banks may have to find a niche – geographic, asset class or counterparty – where they have a competitive advantage.

Banks are being challenged to implement – and to be able to demonstrate the effective working of – a range of improved corporate governance practices.

Supervision

Banks are already on the receiving end of more intrusive and more challenging supervision. This covers not only the more traditional areas of supervisory interest, such as capital and systems and controls, but also much more intensive supervisory focus on liquidity, recovery and resolution planning, the composition and capability of Boards, remuneration (of senior executives, traders and customer sales staff), business models and product design.

This trend of more intensive supervision of an expanding range of banks' activities is likely to continue. The Financial Stability Board has emphasized the importance of more intensive supervision for systemically important banks, and has given a clear message that these banks should be at the top end of the spectrum of bank practices – demonstrating good practice rather than merely acceptable practice. Meanwhile, in the eurozone, the transfer of banking supervision to the ECB may lead to a tougher supervisory approach for some banks. Those subject to direct ECB supervision, or ECB oversight of their national banking supervisor, will also face uncertainties about how exactly this new system of banking supervision will operate in practice – and there is some nervousness about whether the style of supervision will create further challenges.

Governance

Poor standards of corporate governance were one cause of the financial crisis, so standard-setters and supervisors have been active in setting and monitoring banks' performance against a higher and more challenging set of standards. Banks are being challenged to implement – and to be able to demonstrate the effective working of – a range of improved corporate governance practices, including:

- The active involvement of the Board in establishing the bank's strategy, risk appetite, capital adequacy assessment (ICAAP) and culture and values;
- The appointment of non-executive directors with experience and expertise in banking, with the willingness and ability to challenge the senior executive team, and with the time available to perform their roles effectively;
- The effective working of the key Board committees – audit, risk, remuneration and nominations; and
- The effectiveness of risk governance, including the role of the Chief Risk Officer (CRO) in providing the Board of a bank with an enterprise-wide view of risk and an evaluation of the risks inherent in significant changes to the bank's strategy, business model and operations; the ability of the bank to meet high standards of risk data aggregation and reporting; and the ability of the Board to assess the adequacy and effectiveness of the bank's controls.

In response, senior management are having to revisit whether they give appropriate attention to the full breadth of risks arising from their activities, and whether the existing governance framework is effective in defining clear accountabilities for the identification, measurement and management of all risks and their control within the business. The relative roles of business management and independent control functions are under particular scrutiny, as is the definition and focus on operational risk – a source of major risk failures reported in the last year, including further mis-selling, manipulation of markets, and money laundering breaches.

Banks need to consider the combined and cumulative impact of all these proposals on their business models and on their legal entity and operating structures.

Challenge 2

Responding to the combined and cumulative impact of regulatory initiatives

Most banks are dealing with the major new regulations one by one. This may seem a logical approach, but it poses a risk of missing key inter-relationships and co-dependencies. Banks need to consider the combined and cumulative impact of all these proposals on their business models and on their legal entity and operating structures. The magnitude of reform may threaten the viability of existing business activities and structures, requiring a step change if the bank is to emerge with a viable franchise.[4] We highlight four key inter-relationships here.

1. Structural change

Banks need to assess and respond to the collective impact of pressures for structural change, including:

- Structural separation between retail and investment banking, and the prohibition of some trading activities, as a result of the Volcker rule in the US, the Independent Commission on Banking recommendations in the UK, proposals for structural separation in Germany and France, and the possible implementation of the Liikanen recommendations in the European Union;
- Additional structural restrictions imposed on individual banks by the resolution authorities, to enable those authorities to construct credible and effective resolution plans. These restrictions could include further ring-fencing of critical economic functions, limits on intra-group transactions and the use of shared support services, requirements to simplify group structures, and structural changes to facilitate single or multiple entry resolution approaches;
- Pressure to establish subsidiaries and specific structures in some countries. The US recently proposed that major foreign banks establish holding companies for all US subsidiaries; and
- Ring-fencing of subsidiaries (and branches) by host country authorities seeking to protect their domestic depositors and national economies from problems in banking groups, and to enable host authorities to resolve local entities.

4. See *The Cumulative Impact of Regulation, KPMG in the Netherlands*, September 2012

2. Re-pricing of products and services

Almost all regulatory reform initiatives have an impact on costs, and should therefore be reflected in pricing decisions and – where significant – in decisions on the business activities undertaken.

- **Capital** – higher capital ratio requirements will increase the overall cost of doing business, in particular for highly capital-intensive exposures, while actual and prospective increases in the risk weighting of various types of exposure (in particular for trading book risks and counterparty exposures) will have a material impact on the pricing of these activities;
- **Liquidity** – the LCR and NSFR introduce new funding costs for banks, which will need to be priced into both liabilities and assets;
- **Resolution and bail-in liabilities** – banks will need to factor in the costs of the reduction in implicit government support and, in effect, the transfer of these costs from taxpayers to the holders of bail-in liabilities; and
- **Ring-fencing** – requirements for structural separation and the ring-fencing of local subsidiaries and branches will increase the costs of doing business, in particular from capital and liquidity being trapped within individual entities and therefore not available to the rest of banking groups.

Inevitably there will be a trade-off between client willingness to accept higher prices and lower returns.

3. The capital and liquidity interface

The increasing number and complexity of regulatory requirements reinforces two pressures on banks. One of these is conflicts: moves by banks to meet one regulatory requirement may worsen their position in relation to a different requirement. For example, secured funding may be attractive to both banks and their creditors as a source of longer-term funding, but this may conflict with a requirement on banks to hold a minimum amount of bail-in liabilities and with requirements on banks to hold unencumbered liquid assets to meet the LCR requirement. And the use of mortgages as security will in practice increase the amount of stable funding required under the NSFR. Another example is the likelihood of increasing capital requirements on banks' holdings of sovereign debt, which would alter the balance between the value of these assets to banks for capital adequacy and liquidity purposes.

The other pressure on banks is essentially timing, as they need to ensure that they meet regulatory requirements on a continuous basis. This will require careful planning, especially as improving economic conditions generate balance sheet growth and central banks seek to reduce their provision of liquidity.

4. Collateral management

A number of regulatory reform initiatives will increase the demand for collateral by banks. These initiatives include:

- **Liquidity** – banks will be required to hold high quality liquid assets that have to be unencumbered, and which cannot therefore be used as collateral for other purposes;
- **Resolution and bail-in liabilities** – wholesale depositors will have an incentive to lend to banks on a secured basis to avoid the threat of being bailed-in if a bank has to be resolved. Movement of funds across borders in an RRP focused world could become more challenging on the one hand, and increasingly necessary for intra-group purposes on the other;
- **Capital requirements** – the capital requirements for unsecured/uncollateralized exposures have, in general, increased by more than those for secured/collateralized exposures;
- **Contingency planning and stress tests** – banks are being required to hold buffer stocks of collateral to protect themselves against the possibility of being downgraded and having to put up additional collateral as a result;
- **Derivatives** – the central clearing of derivatives will require more derivatives trades to be collateralized, with higher quality assets; and
- **Systemic risk and shadow banking** – proposals here include limits on the re-hypothecation of collateral through enhanced segregation of client assets and higher collateral requirements on repo and other secured lending transactions.

Taking the opportunity to combine liquidity planning and the impact of the central clearing of derivatives with an overall assessment of collateral management is key. Our clients are looking at how they can improve data, systems and processes to support better real time assessments of what collateral is available and its most effective deployment.

Together, these pressures may lead some banks to consider significant changes to their group structures, and to their national and international business activities.

The other pressure on banks is essentially timing, as they need to ensure that they meet regulatory requirements on a continuous basis.

Challenge 3

Combining regulatory reform challenges with other challenges – and shaping strategic direction and business models accordingly.

Although banks face a wide range of challenges, including macro-economic and competitive, we focus primarily here on the more internal operational challenges facing banks, and on how these ever-present and continuing challenges interface with the current waves of regulatory reform. Developing a new operating model will not, in itself, position a bank to succeed in the new market – this is only part of the overall challenge. Even if the operating model is very sophisticated, it will not realize its full potential unless there is a strong governance framework surrounding it.[5]

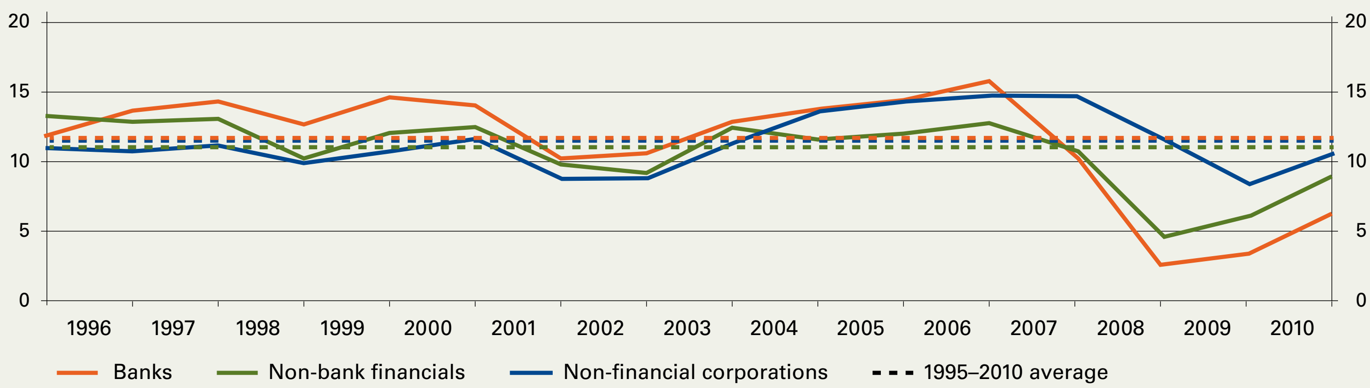
Moving away from the old models

The banking model of the past two decades can be characterised in two ways. First, banks were seeking economies of scale through services that were centralized nationally, regionally or globally, combined with the exploitation of internal synergies through the consolidation of core IT systems and integrated operations centres to drive efficiency improvements. Regulatory and business model pressures are forcing banks to consider taking a different approach, with a move away from single IT platforms and a single set of shared services towards establishing each business unit with its own operational centre. Banks are being pressed by national supervisors to repatriate core activities from regional or global shared services to their respective domestic jurisdictions. Successful new models have not yet fully emerged, but they may look radically different from the old one. The centralized bank may become a thing of the past, replaced by an entity that is more local.

Second, banks historically pursued a strategy of volume growth. Now, however, the industry is shrinking and overall economic growth in Europe is stagnating, at best. Given subdued market conditions, significant cost reduction is critical in closing the gap between current and long-run median return on equity – as shown in the chart below. Yet the cost of compliance is soaring and, along with it, the amount of investment in the systems required to enable banks to monitor themselves and to report to the authorities. The unit cost of supplying retail services is rising sharply – for example, the cost of running branch networks usually makes up around 75 percent of a retail bank's total distribution costs[6] – but banks find it difficult to pass on these costs to their customers because they are perceived as public utilities. One method of reducing costs would be to close retail branches, but this carries reputational risk. In some European countries where governments are now significant shareholders it is politically difficult to cut back on banking services. But in countries such as Spain, the number of branches is falling sharply as banks try new ways to acquire more customers with fewer outlets.

The success of both of these shifts from earlier banking models will depend on banks increasing their efficiency in the current environment, which will require something more deep-rooted than conventional downsizing. With

Median return on equity (Net income over total shareholder funds; in percent)



Source: Bloomberg; BIS calculations.

Developing a new operating model will not, in itself, position a bank to succeed in the new market – this is only part of the overall challenge.

`quick win' cost reductions increasingly exhausted, many of our clients have now initiated fundamental reviews of business areas and supporting infrastructure. They are facing up to difficult choices not just about what businesses to be in, as described above, but also about where to invest for growth with increasingly scarce capital. Previous high margins in many organizations were sustained through starving core infrastructure and functions of the necessary development to generate efficiencies and support more effective risk management and compliance.

The focus is now shifting to sustainable cost reduction supported by targeted investment in simplifying operations, such as straight-through processing that minimizes human input in bank processes – increasing efficiency and embedding controls; first-time resolution, where processes such as opening a bank account would be done in one step rather than multiple stages; and greater use of self-service channels in which customers conduct more bank activities without the need for human intervention by the bank.[7] Banks may at least not need to make expensive investments in user interfaces for their retail customers, since many of their clients have smart phones and tablets that can do the work.

Shifting geographies and international business models

Many global and European banks are also re-evaluating their international footprint and structure, re-assessing key elements such as where they book business and legal entity structures. Some are rationalising and simplifying their legal entity structures, and considering the relative merits of branch and subsidiary structures.

In Eastern Europe, the international banks that never gained a foothold either have withdrawn or are likely to pull out. But the more established players are likely to stay. Many of them are making higher profits there than in their home country, partly because their costs are lower.

Spanish banks have disposed of their non-core assets, including insurance subsidiaries and asset-management companies. In France and Switzerland, banks are pulling out of business areas, restricting client activity and making significant staffing cuts. In the UK, while many banks have not yet reduced their suite of products, this will have to come. The Swiss bank, UBS, recently announced that it is divesting its non-core business and moving to more of a wealth management and private banking focus. Other European investment banks are also taking large steps in changing their business models, pulling out of some markets and focusing business activities elsewhere, for example, Deutsche Bank's recent public announcement that it is reducing non-core risk-weighted assets.

The scale of these changes can already be seen in the slow but steady reduction in bank headcount, post-crisis. There was a 6.5 percent drop in EU bank employment between 2008 and 2011[8], while in the last year, 29 major banks announced job cuts of at least 160,000[9]. And there will be more to come as banks continue to restructure.

5. See *Optimizing banking operating models: From strategy to implementation*, KPMG in the UK, September 2012
6. *Trends in Retail Banking Channels: Improving Client Service and Operating Costs*, CapGemini, 2012
7. See *Optimizing banking operating models: From strategy to implementation*, KPMG in the UK, September 2012
8. Source: *European Banking Sector Facts and Figures*, European Banking Federation, 2012
9. Source: Thomson Reuters, November 2012

Optimising Business and Control Functions

The changes in business model, combined with specific changes in regulation, together create major new challenges for the core business and control functions of banks – finance, risk, treasury and compliance. These functions must change the way in which they interact, both with each other and with front line business management, if they are to increase the effectiveness and efficiency of their services. New business models and extensive new regulations require new approaches to building and operating an effective risk and compliance framework. Control functions must play a critical role in shaping and delivering necessary business change to ensure compliance is built in – rather than bolted on – to key business processes.

A critical challenge is re-balancing the accountabilities of risk and compliance functions relative to business managers. Lack of clarity over ownership and understanding of the full set of risks by business managers has led to a lack of focus and investment on the identification, measurement and control of many risks. Risk functions have instead found themselves acting as the owners, operators, advisers and assurers of both risks and controls. Light touch policies applied from the Group level have allowed divergence in practices, language, measurement and reporting of risk and controls. This lack of clarity and consistency has led to inefficiencies through duplicated effort, and also the operational gaps at the heart of so many operational failures throughout 2012.

Regulators have observed this and have re-emphasized the role of business management in risk and control, and are looking for improved practices which are applied across the business. The recent BCBS principles for Risk Data Aggregation and Risk Reporting, published in January 2013, lay the groundwork for a way forward by requiring greater consistency of risk information across the business, to enable more accurate and timely data aggregation, while emphasizing the importance of business ownership over risk data, risk reporting, and its effective control. While costly and complex, implementing these proposals well provides businesses with significant opportunities.

The regulatory agenda affects every aspect of how a bank controls compliance of its operations. The challenge of how to manage capital, liquidity – and collateral – becomes crucial to optimizing business decisions and returns. This is where business managers, risk, finance and treasury come together. The scarcity and cost of both capital and funding requires a more integrated approach to capital buffers, supported by more comprehensive and inclusive re-charging to businesses. And reliable data, which can be generated and aggregated quickly, will be a critical enabler.

IT investment

Maintaining consistent and reliable data to support management and financial analysis – covering everything from line management decision support requests, through to formal regulatory reporting – is a huge challenge for many banks, in the face of the spider's web of legacy systems and multiple, separate pools of data which are common today.

Banks will have to continue to invest heavily in technology if they need extensive changes to their operating models as a result of regulatory requirements, for instance to separate high street banking from 'casino' banking operations. The additional pressures generated by separating or structuring businesses by activity or geography may also mean that the current IT architectures at the heart of global banks will require extensive re-work in order to better reflect new operating models, new organization structures and new regulatory regimes.

The existing architectural and IT platform structure within a bank often reflects what was required to support historic legal entity and regulatory reporting structures. There are significant architectural challenges presented by the need to adopt radically different operating models and reporting requirements, for instance to create greater control of individual business units on a standalone basis, while still being able to create end to end process efficiencies and end to end control environments to deliver an integrated picture of the Group to management or external regulators.

There are increasing and potentially conflicting demands for changes to certain key processes, for instance, client on boarding processes and regulated or advised sales processes. These changes could be driven by business management, eg. operational cost reduction achieved through improved operational efficiency (better process automation), or cost reduction through improving the proportion of transactions delivered by customer self-service (increased leverage of digital channels) or they could be driven by a desire for increased revenues, for instance by enabling a better sales process for new products from better managing the servicing of the banking back book products. These changes will potentially affect the same people, processes and technologies as other regulatory driven changes, for instance, to address or monitor Conduct Risk.

Maintaining consistent and reliable data to support management and financial analysis is a huge challenge for many banks.

The traditional approach to providing a new regulatory reporting requirement within a bank has often been to develop a specific additional IT solution comprising data collection, data storage and reporting. It is quite normal to have multiple, parallel processes and multiple, parallel solutions producing essentially similar outputs quite separately. The parallel processes, teams and technologies might exist because the output of one is intended for internal management and another is for the external regulator, or because one process is controlled by Finance and another is controlled by Risk, or because one is a business unit reporting function and the other is a Group reporting capability.

It is also much more common for projects to deliver additional solutions to the architecture than for a project to actually decommission platforms, databases or infrastructure. The underlying data and reporting architecture has therefore become increasingly complex, increasingly fragmented and increasingly difficult to standardise and control year by year. Few banks have had the bandwidth, appetite, or budget to take a step back and work out what the right solution really is for the bank going forward, rather they have had to deal with individual projects in isolation.

Much, although not all, of the change demand comes from regulators, including:

- Increased requirements for data from banks to improve the ability of both micro- and macro prudential regulators to understand better the financial system and the risks to financial stability. Regulators are demanding more information from banks about their credit and market risk exposures, their liquidity positions, and their interactions with other parts of the financial system, including shadow banking.
- Increasingly detailed and granular data from banks relating to compliance with regulatory rules. Regulators in Europe are working on Common Reporting Standards (COREP) that promise to establish a common framework based on common formats. This may eventually standardize reporting solutions and processes – and reduce duplication – but it is likely to take several years. The use of Extensible Business Reporting Language (XBRL) is designed to help banks to standardize and analyze data, however switching from legacy structures and standards to new formats will not be a trivial exercise.
- Higher standards of data aggregation and data reporting by banks, to enable them to identify and monitor risks more accurately and in a more timely manner, and to be in a position to run stress and scenario tests more effectively. In future, regulators will require reports that go deeper into the underlying health of particular businesses and their ability to cope with external shocks. Regulators emphasize the need for this enhanced capacity not only to meet regulatory demands but also to improve risk governance in the banks themselves.

  Most crucially, banks themselves need better data management ie. underpinning improvements in data governance, data ownership, data management and in how data is consumed across front and back-office functions, financial reporting teams, etc in order that authenticated and accurate data can be leveraged to gain a deeper, richer view of their customers through data analytics for instance.

For many, the main challenge is the fragmented application and data architecture with pockets of data distributed across different silos, resulting in data redundancy, data duplication and data inconsistency.

Banks have invested huge sums in building complex systems to meet reporting and compliance requirements, often with significant ongoing challenges in keeping the systems and data up to date as a result of, for example, in-flight projects and emerging regulations. A few organizations have been able to adopt a more radical approach of significantly rationalizing applications, data repositories and End User Computing tools to make processes and systems smaller, more efficient and more flexible. These organizations can look at the forthcoming portfolio of changes with significantly greater confidence.

Challenge 4

Restoring customer focus and trust in banks by tackling the deep-seated issues of culture and behavior.

A combination of the financial crisis, the continuing mis-selling of financial products in many countries, the LIBOR fixing scandal and the continuing incidence of market abuse and money laundering, has not only undermined confidence in banks but also raised fundamental questions about their culture and behavior. Intense political focus has continued – for example, the Parliamentary Commission on Banking Standards in the UK. These developments have in turn led to a growing recognition from the most senior levels in banks of the need for cultural change.

In part, culture and behavior is being addressed through regulatory reform. Capital and liquidity measures are designed to increase the cost of risk-taking; structural separation measures should highlight the need for banks to take different approaches to their retail and investment banking activities; resolution measures are designed to reduce risk-taking by removing the prospect of government support if banks fail; governance measures are intended to heighten the focus of Boards and senior management on risk; remuneration measures are designed to reduce the incentives for inappropriate and excessive risk-taking; and conduct measures increasingly focus on both the design and distribution of financial products and on the incentives of retail customer-facing sales and advice staff.

However, although regulation, rules, codes, professional bodies and even enforcement might all help to generate and preserve momentum around cultural change, they will never be enough. Ultimately, culture is something that only the banks themselves can change.

So the real challenge is to recognize all the forces that have generated poor behaviors and to introduce cultures and behaviors that result in outcomes that are more closely aligned with customer expectations and regulatory requirements.

Some banks have begun to address these cultural and behavioral issues in the context of customer treatment. In Europe, British and Irish banks have taken the lead in focusing more on the customer, and the rest of the Europe, Middle East and Africa region seems to be moving in the same direction, with specific policy developments in Germany and South Africa, for example.

Some are moving back to a more traditional, branch-based model. Others are looking at reducing the number of branches to keep costs down, but making better use of new technology – in payments, mobile and online banking, as well as online communication and social media – to connect with and provide services to customers. Sustainable improvements in efficiency require both innovation and a deep understanding of the customer's requirements. Customers want cheaper, faster services that respect their time. They also want a secure and trustworthy relationship with their bank and financial advice that is relevant, useful and timely.

It may seem difficult, not to mention contradictory, to improve customer service at a time when banks are also seeking to cut costs, but this is a fundamental objective in the new era

Although regulation, rules, codes, professional bodies and even enforcement might all help to generate and preserve momentum around cultural change, they will never be enough...

Banks that place customers at the centre of what they do are likely to enhance their reputations.

of banking. In fact, good customer service is actually cheaper to deliver than poor customer service, not least because of the cost of internal resources, remediation and financial penalties following poor customer service.

Banks that place customers at the centre of what they do are likely to enhance their reputations. Banks should be able to shift away from a focus on short-term transactions and return to building a longer-term relationship with clients, if they operate on the basis of customer-centricity, prudence and mindfulness of reputation.

However, many banks will find it difficult to achieve the necessary shifts in culture and behavior. It is important to recognize that short-term profitability may not be closely aligned with the fair treatment of customers and good customer service, especially in markets – both retail and wholesale – where customers are unable or unwilling to engage on an informed basis. The old mantra of 'what is good for business must also be good for customers' has been shown to be seriously flawed, with too many cases of banks placing their own interests ahead of the interests of their customers. Moreover, the industry has been very slow to recognize and address these problems, or to accept that the cultural and behavioral issues cannot be solved simply by high-level statements about 'putting customers first' and by blunt adjustments to remuneration structures. There is a clear need to assess and prepare for what will be good for long-term business.

Another key challenge is that some decisions may no longer be solely for the banks themselves to take. Politicians and regulators have become more interventionist, in terms of what banks should look like (for example, the various interventions on bank structure), the business models that banks can pursue, what banks should do (for example the pressure on banks to maintain lending, in particular to small and medium size enterprises in their home country), what products banks should sell, and how they should advise on or sell these products. There have been two main drivers of this: the enormous costs to society of bank failures and the succession of scandals involving banks.

A view from Asia-Pacific

European banks face a multitude of issues in Asia, as a result of requirements emanating from the international supervisory bodies and national/regional supervisory bodies; and because of consequent actions by host supervisors.

It is clear that there are many factors for European banks to consider when planning their strategies and assessing their regulatory compliance requirements in Asia. Key considerations include:

Subsidiarization and separation

We have not yet seen the full extent of the restructuring of European banking groups that will be required if the Independent Commission on Banking and Liikanen proposals are implemented, and if European supervisors require substantial restructuring to make major European banking groups more 'resolvable'. (We discuss current European proposals in more detail on pages 36–37.)

Host supervisors in Asia are clearly anticipating that such restructuring will push the priority and support given to Asian operations further down the pecking order. And the natural response of host supervisors in such circumstances is likely to be to apply additional ring-fencing requirements on the local operations of foreign banks, including subsidiarization (or locked-up branch capital), particularly when the activities in the local market are substantial and/or of a retail nature. To date, we have seen several supervisors in Asia considering subsidiarization. There is a need to balance protecting the local market with encouraging continuing involvement by foreign banks.

Several regulators in the region have also been tightening up on outsourcing, particularly cross-border, and including intra-group, which may present an obstacle to some European banks seeking to enhance the cost-efficiency of their operations in Asia.

Interestingly, however, the idea of splitting core banking and trading activities – currently the subject of much debate in Europe and the US – has not been taken up by supervisors in Asia, where trading activities are generally modest and not seen as a concern. Several supervisors in Asia have explicitly continued to endorse the universal trading model that tends to be the norm in Asia – they see no need to split trading from other banking activities.

This means that the shape of European banks' trading activities in Asia and their legal entity structure for trading are likely to be influenced more by home country/European requirements than local requirements.

The liquidity challenge

Liquidity is another issue where local requirements come into play. Several Asian supervisors are indicating that, notwithstanding whatever requirements home supervisors may place on the group, they will also be subject to local requirements. This is likely to mean that they will need to increasingly fund their local operations on a largely stand-alone basis, with limited reliance on intra-group funding. There is also the possibility (as in Hong Kong) of these requirements applying to foreign banks that operate as branches, as well as to subsidiaries.

In addition to the issue of the scope of application of the liquidity requirements, there is also the issue in many Asian markets of the shortage of assets meeting the definition of high quality

liquid assets, which further complicates meeting the requirements.

This issue of funding is key for European banks – and foreign banks generally – that have largely relied hitherto on global (intra-group) or local wholesale (interbank) funding and lack retail funding penetration in Asia. On the other hand, those European banks with a strong retail presence in the region are well placed.

Re-evaluating the geographical footprint

Subsidiarization (requiring local capitalization), local funding and the localization of key functions and systems will all tend to raise costs and possibly change the cost/benefit equation significantly. It is not surprising that some European and other banks are evaluating their geographical footprint in Asia, considering which markets they want to operate in. Ultimately, the funding issue is causing the greatest amount of soul-searching. This is likely to be the number one factor in shaping the European banks' operations in Asia.

We have already seen deleveraging and drawing back from lending by some European (and other foreign) banks. The possible scaling back of operations in Asia by some does, however, present opportunities for 'stayers' to acquire business (on both the asset and liability side) and add to scale.

Generally, foreign banks, including European banks, remain committed to their Asian operations. For many, Asia is where they anticipate growth and an opportunity to rebuild their profitability.

It is quite possible that we will see a substantial increase in the business booked in Asia, as a number of investment banks are understood to be looking at their (global) booking models – in particular, considering booking their Asian OTC derivatives business in Asia rather than offshore.

Implementing Basel 3

Implementation of Basel 3 in Asia is far from straightforward for international banks. While they will tend to be most familiar with the Basel standards and the home country/European requirements, the requirements in each Asian jurisdiction may differ in important respects – there is no central coordinating body in Asia promoting a consistent regional approach. In a number of cases we have seen regulators in the region – in China and Singapore, for example – setting requirements above the Basel minimums in areas such as capital adequacy and leverage, in order to reflect the characteristics of the local market.

Unlike Basel 2, which international banks were generally able to implement first in their home market and then roll out subsequently to other geographies, in the case of Basel 3, now that many Asian countries are Basel committee members and implementing to the same timeline, banks may well need to implement in multiple geographies simultaneously. Indeed, several territories – including Australia, China, Hong Kong and Singapore – look like they will be implementing Basel 3 ahead of Europe and the US.

Where will we end up?

Looking a little further ahead, Asian supervisors are now considering what requirements to impose on domestic systemically important banks (D-SIBs). These may also be applied to some local operations of European banks and are likely to include requirements to develop local Recovery and Resolution Plans (RRPs).

So, although we may be moving towards something more like a level playing field in terms of the minimum standards on capital, liquidity, leverage, RRPs and so on, it is clear that there will remain considerable differences in requirements (such as the timing of implementation and the scope of application) from jurisdiction to jurisdiction.

More detail on the specific challenges facing banks in the region can be found in *Evolving Banking Regulation 2013 – ASPAC Edition*.[10]

Several regulators in the region have also been tightening up on outsourcing, which may present an obstacle to some European banks seeking to enhance the cost-efficiency of their operations in Asia.

10. *Evolving Banking Regulation 2013 – ASPAC Edition*, KPMG, February 2013

A view from the Americas

Regulatory uncertainty

While US financial regulators have continued to make progress in the rulemaking and interpretation required for implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), much uncertainty remains. Some rules, including requirements for resolution and recovery plans, adoption of Basel 3, and the Volcker Rule ban on proprietary trading are in general targeted directly at the global activity of US headquartered institutions or the domestic activity of foreign owned US subsidiaries. These alone, once finalized, will result in significant changes for foreign firms in their US operations and also may change the nature of business transacted with US institutions elsewhere.

As with other regulators, US policymakers are keen to ensure that any activity which could affect the stability of the US financial system is subject to its (or very similar) rules and that activity which is substantially associated with US markets or US counterparties cannot readily move offshore to circumvent these rules. Proposals have been released by US regulators in this regard over the last twelve months. However, significant criticism from policymakers and financial institutions alike means that the requirements have yet to be finalized. It is critical for banks to continue to monitor developments, as some level of extraterritorial compliance is likely to be required.

Derivatives rules

In July 2012, the CFTC released proposals for the applicability of its new derivatives clearing requirements to cross-border swaps. Its key proposals were:

- US and foreign firms dealing in swaps with US persons will be expected to register as a Swaps Dealer (SD) or Major Swaps Participant (MSP) as appropriate if a de minimis threshold of US$8 billion notional value in swaps is contracted with US persons per annum across all non-US affiliates;
- Non-US SDs will be subject to 'entity level requirements', including business conduct standards and additional annual reporting requirements, but they can apply for substituted compliance;
- Additional 'transactional requirements' (eg. clearing obligation, margin requirements and segregation) will apply only to trades where one party is a US person, but substituted compliance is again possible; and
- Dealing with a branch of a US-based institution will not subject a non-US SD to transaction requirements or count towards calculating the threshold for registration as a foreign SD.

It is critical for banks to continue to monitor developments, as some level of extraterritorial compliance is likely to be required.

Challenges to the potential for onerous application and to the interpretation of local rules to agree substituted compliance were raised by both financial institutions and foreign regulators and governments. Sweeping definitions of US persons and a requirement to aggregate all trades across all affiliates were also highlighted as having the potential to cast the net too widely.

Against this backdrop, the US regulators were co-signatories to a joint declaration issued by supervisors from all major financial markets agreeing a framework and arrangement to map out an effective means of cooperation and recognition for derivatives requirements. Further progress is expected in the first half of 2013, but for the moment it appears to lay the groundwork for more acceptance of local rules and supervision which – if effective in practice – could significantly lessen the regulatory burden on market participants. Nonetheless, some level of reporting and monitoring on behalf of multiple supervisors is likely to remain for those banks with significant cross-border activity.

US proposals for foreign banking organizations

In December 2012, the Federal Reserve Board announced proposed rules to strengthen the oversight of the US operations of foreign banks. These rules would require foreign banking organizations with a significant US presence to create an intermediate holding company over their US subsidiaries and to hold stronger capital and liquidity positions in the US. The proposed rules include:

- A foreign banking organization with both (i) US$50 billion or more in global consolidated assets and (ii) US subsidiaries with US$10 billion or more in total assets would be required to organize its US (bank and non-bank) subsidiaries under a single US intermediate holding company (IHC).
- IHCs of foreign banking organizations would be subject to the same risk-based capital and leverage standards as apply to US bank holding companies.
- The US operations of foreign banking organizations with combined US assets of US$50 billion or more would be required to meet enhanced liquidity risk-management standards, conduct liquidity stress tests, and hold a 30-day buffer of highly liquid assets.
- Additional measures regarding capital stress tests, single-counterparty credit limits, overall risk management, and early remediation.

The Federal Reserve is proposing a phase-in period to give foreign banking organizations time to adjust to the new rules. Foreign banking organizations with global consolidated assets of US$50 billion or more on July 1, 2014 would be required to meet the new standards from July 1, 2015.

These proposals would have major implications for foreign banks operating in the US who do not currently follow an IHC structure and do not currently hold sufficient capital and liquidity to meet such requirements.

More detail on the specific challenges facing banks in the region can be found in *Evolving Banking Regulation 2013 – Americas Edition*.[11]

11. *Evolving Banking Regulation 2013 – Americas Edition*, KPMG, February 2013

The regulatory landscape

An update on EMA region regulatory reforms

Capital

The Basel 3 capital requirements were due to be implemented on January 1, 2013. In the European Union, the European Commission largely copied out the Basel 3 standards into a proposed Capital Requirements Regulation (CRR) and revised Capital Requirements Directive (CRD 4) in July 2011. But the Directive has still not been finalized as discussions continue between the Commission, the EU Council and the European Parliament. It is, however, expected that the CRR and CRD 4 will be agreed in 2013, with implementation beginning January 1, 2014. This is not a serious delay, because many of the new standards are due to be phased in by 2019.

Many banks face massive shortfalls in meeting the Basel 3 capital requirements. Applying the final (as from 2019) Basel 3 standards to banks' end-2011 balance sheets shows a shortfall across 44 internationally active European banks of €200 billion of common equity tier 1 (CET1) capital against the 7 percent minimum ratio, and a further shortfall of €26 billion across 112 domestic European banks[12]. The results show some progress from previous impact studies – these shortfalls are around 20 percent smaller than at end-June 2011.

Banks may not have as long as the Basel 3 transition timetable suggests in meeting these shortfalls. National supervisors, the European Banking Authority (EBA), investors, market

Banks may need to hold even higher amounts of capital to meet a wide and expanding range of additional capital requirements.

12. European Banking Authority: Results of the Basel III monitoring exercise based on data as of 31 December 2011, September 2012

Revisions to the LCR should have a positive impact on bank lending and the real economy, by reducing the costs to banks of meeting the LCR.

analysts and rating agencies are already putting pressure on banks to meet the Basel 3 requirements more rapidly than the transition timetable.

Banks may also need to hold even higher amounts of capital to meet a wide and expanding range of additional capital requirements. These include capital surcharges on global and national systemically important banks; the implementation of macro-prudential tools such as the counter-cyclical capital buffer and cyclical adjustments to sector-specific capital requirements; the implementation by some European countries of the new 'systemic risk buffer' that has been added to CRD 4 and can be used by national authorities to mitigate long-term structural systemic risks such as the size of a country's banking sector as a proportion of GDP; the continuing application of 'Pillar 2' supervisory add-ons; and individual banks choosing to hold their own buffers over and above minimum regulatory and supervisory requirements.

Higher capital requirements are also likely to arise from regulatory adjustments to the denominator of the capital ratio. The Basel Committee is consulting on introducing higher capital requirements on banks' trading books and is reviewing why the risk weightings on both banking and trading book exposures differ by so much across banks that use their own internal risk models and are so much lower than the standardised risk weightings. This may result in stricter requirements on internal risk models, and a greater focus by supervisors on capital ratios calculated using the standardised risk weightings, or introducing capital floors based on these, even for banks that use their own internal risk models.

This theme of how banks can justify the risk weightings derived from internal models was also picked up in a review by the European Banking Authority with a sample of 19 major banks' Pillar 3 reports. They criticized banks for not providing adequate 'back-testing' disclosures that compare actual and expected losses over a period of at least three years. A report from the Enhanced Disclosure Task Force (EDTF), a private sector working group created by the Financial Stability Board in May 2012, emphasized the need for banks to report in more detail and on a much more consistent basis to enable analysts to reach a clearer view of how risk weighted assets correlate with risk and with actual loss experience.

Finally on capital, the 44 internationally active European banks in the EBA impact study also had collectively a small shortfall against the proposed leverage ratio (2.9 percent on average against a minimum leverage ratio of 3 percent to be applied as a binding requirement from 2018). This may become more problematic for banks if regulators begin to focus more on 'simple' rules and begin to press for a tougher minimum leverage ratio in that context.

Liquidity

Although much attention has focused on the Basel 3 capital adequacy requirements, the forthcoming global standards for managing liquidity risk are likely to pose an even greater challenge for some banks.

Basel 3 proposes two key liquidity ratios. The Liquidity Coverage Ratio (LCR) is designed to strengthen the ability of banks to withstand adverse shocks. It will require banks to hold sufficient high-quality liquid assets (including cash, government bonds and other liquid securities) to meet a severe cash outflow for at least 30 days. The Net Stable Funding Ratio (NSFR) is intended to ensure that banks hold sufficient stable funding (capital and long-term debt instruments, retail deposits and wholesale funding with a maturity longer than one year) to match their medium and long-term lending.

The LCR is due to become a minimum requirement on banks in 2015 and the NSFR in 2018. According to the EBA, internationally active European banks faced large shortfalls against both these new liquidity ratios at the end of 2011, with an average LCR of 72 percent and NSFR of 93 percent. However, banks will obtain some relief from the revisions to the LCR announced by the Basel Committee in January 2013, following a series of impact studies, industry comment and discussions.

These revisions to the LCR will relax the earlier Basel 3 proposals in three main ways. First, banks will be given more time to build up their liquidity buffers, with the minimum LCR requirement set at 60 percent from January 1, 2015, then increasing by 10 percentage points each year until the permanent minimum requirement of a 100 percent ratio is reached in 2019.

Second, banks will be able to hold a wider range of high quality liquid assets, with the inclusion of equities, securities backed by residential mortgages, and a wider range of corporate bonds – albeit with restrictions on the quality of these assets, the imposition of large haircuts on the value of each asset that can be counted, and narrow limits on the total amount of such assets that can be included in a bank's high quality liquid assets.

Third, banks will be subject to less severe assumed 'run-off rates' on some of their liabilities and commitments.

These revisions should have a positive impact on bank lending and the real

In the European Union, it is still not clear where, how and when the capital surcharges for both G-SIBs and D-SIBs will be covered in EU legislation.

economy, by reducing the costs to banks of meeting the LCR and, more specifically, through the more generous treatment of committed facilities and trade finance and by encouraging the securitization of good quality mortgages. In Europe and elsewhere, the revisions should also make it easier to apply the LCR to all banks, not just the large internationally active banks.

Since the European Commission copied the earlier versions of the two liquidity ratios from Basel 3 into the draft Capital Requirements Regulation, it is expected that these revisions to the LCR will be implemented in full in Europe.

Meanwhile, the Basel Committee has re-affirmed its intention to introduce the NSFR – but it was always intended to allow a longer observation period for this second ratio, with implementation as a binding requirement on banks from 2018.

Systemic risk

In addition to the Basel 3 package of tougher capital and liquidity standards, which in Europe will be applied to all credit institutions and major investment firms, the international standard-setting authorities have also been focusing on a wide range of measures directed primarily at systemically important banks. The purpose of these measures is to reduce:

- The likelihood of a systemically important bank failing in the first place;
- The costs (to the rest of the financial system and to the wider economy) of the failure of a systemically important bank; and
- The implicit or explicit public subsidy to systemically important banks, by removing the need for taxpayer-funded support of a failing systemically important bank.

Capital surcharges

The Basel Committee has developed a set of five criteria for identifying global systemically important banks (G-SIBs), and has established a range of capital surcharges (additional core equity tier 1 capital) to be applied to these banks. The intention is to update the list of G-SIBs and to consider the capital surcharges that should apply to each of them in November each year. Surcharges will begin to be applied from January 2016 (with full implementation by January 2019), for G-SIBs identified in November 2014.

At November 2012, the list of G-SIBs included 28 banks, with four of them subject prospectively to a 2.5 percentage points capital surcharge.

Meanwhile, national authorities are also expected to identify banks that are of national systemic importance (so-called D-SIBs), and similarly to impose capital surcharges on them, although the Basel Committee has been much less prescriptive about both how D-SIBs should be identified and the range of capital surcharges that might be imposed. Considerable national discretion has been left here.

In the European Union, it is still not clear where, how and when the capital surcharges for both G-SIBs and D-SIBs will be covered in EU legislation. This will have an impact on the extent of national discretion available with respect to D-SIBs, and on the interplay between these capital surcharges and other capital requirements, including 'Pillar 2' capital add-ons for individual banks and the national application of sector-wide systemic risk buffers.

Recovery and Resolution Planning

In the European Union, the European Commission published a draft Directive on Recovery and Resolution (RRD) in June 2012. This follows the Financial Stability Board's 'key attributes' for resolution, including requirements on banks and national authorities. The primary requirements are:

- The recovery plans that firms will need to put in place, with the EBA mandated to develop robust and severe stress and scenario tests that a bank should be able to recover from, not only through contingent capital and liquidity arrangements but also by selling assets and business lines if necessary;
- The information that firms will have to provide to enable the authorities to draw up resolution plans for each firm – national resolution authorities (and colleges of such authorities for cross-border groups) will then have to assess whether a credible resolution plan can be constructed. The emphasis here will be on how easily critical functions and core business lines could be legally and economically separated to ensure their continuity, how access to payment and settlement systems could be maintained, whether service level agreements would remain in place during resolution, the adequacy of management information systems, and the impact of group structure, intra-group exposures and other intra-group arrangements on the potential separability of particular functions or business lines;
- A common minimum set of powers under which national authorities could require firms to improve their recovery plans and to change in advance their businesses and structures to make them easier and less costly to resolve;
- A requirement for firms to hold 'bail-in' liabilities that could be written off in the event of a resolution. The RRD would require national resolution authorities to be given powers to trigger a bail-in of liabilities if a bank

goes into resolution. The authorities could then write down (or convert into equity) the claims of the creditors of a failing bank. This would extend beyond capital instruments to a wide range of uninsured and unsecured liabilities. The RRD also includes provisions for a deposit guarantee scheme (but not insured deposits) to bear some of the losses of a bank in resolution. As currently drafted, the RRD does not set a minimum ratio for banks' holdings of bail-in liabilities, but suggests that national authorities should determine this on a bank-by-bank basis, taking into account the amount of bail-in liabilities that would be required to meet the resolution objectives and to enable a bank to be recapitalized, which is a function of its size, business model, risk profile and the systemic importance of each bank;
- A common minimum set of powers and tools which national authorities could use to resolve a failing firm; and
- The pre-funding of national resolution funds.

The RRD applies to all credit institutions and to major investment firms, rather than just to banks or systemically important firms – although national authorities can apply the requirements proportionately to non-systemic firms.

It remains unclear when the RRD will be finalized and implemented. The original intention was that the RRD would come into force in mid-2013 and be transposed into national legislation by the end of 2014. Provisions relating to the bail-in tool would not apply until the beginning of 2018, to allow time for existing liabilities to mature, to avoid deleveraging and to align with the full implementation of the new capital requirements.

Resolution in practice

In December 2012, the Bank of England and the US Federal Deposit Insurance Corporation (FDIC) issued a joint paper on the resolution of global systemically important financial institutions. The most important aspect of this paper was confirmation that the Bank of England intends to follow where possible a top-down 'single point of entry' approach to the resolution of major banking groups, where bail-in liabilities are held in the ultimate parent company of the group. This is not inconsistent with the RRD, although in general the RRD is based more on a 'multiple points of entry' approach, whereby each subsidiary of a group would hold its own bail-in liabilities.

The main implication of a 'single point of entry' approach to resolution is that major UK (and US) banking groups would have to put into place:
- A group structure based on a parent holding company;
- The ring-fencing of (domestic and overseas) subsidiaries that undertake critical economic activities, so that the continuity of these activities can be more easily maintained in a resolution;
- Sufficient debt issuance at holding company level to enable the group to be recapitalized in a resolution through the conversion of this debt into equity; and
- Using this holding company debt to make loans to subsidiaries, so that subsidiaries can be supported in a resolution through writing off these loans.

An alternative approach could be applied to a major banking group that is funded mostly through retail deposits. This would apply the provision in the RRD to treat a deposit guarantee scheme as a creditor that can be bailed-in, with the costs of this falling on other banks that have to fund the scheme.

It is not yet clear how far colleges of resolution authorities will be able to commit to resolution strategies in advance. Other supervisors hosting US or UK cross-border groups have yet to comment on whether they agree with the proposed approach.

Resolution of client assets

Important steps are being taken to protect the assets of customers in the event of the insolvency of the financial institution holding the investments. In the past, customers might have assumed that, if their assets were segregated, they would be able to gain access to them quickly if the institution collapsed. But the collapse of Lehman Brothers and MF Global proved this to be a false assumption.

The Client Assets Sourcebook (CASS) Resolution Pack, which went into effect in the UK in October 2012, attempts to provide a framework for clients to reclaim their assets in such extreme situations. Banks are required to provide a complete database of information on customers, counterparties, systems and accounting records within 48 hours of the appointment of an insolvency practitioner. Clients and their assets change on a continual basis, so financial institutions will need to update their CASS Resolution Pack on a daily basis. The EU is pursuing similar initiatives within other policy papers, including EMIR and the proposed Regulation for Central Securities Depositories, which introduce requirements for individual segregation.

In September 2012, the UK FSA also released a Consultation Paper proposing extensive change to the UK CASS regime. It initially proposes rules to amend the UK CASS regime to allow for the option of individual segregation provided for under EMIR (where clients, both direct and indirect, must be offered the option of holding assets in a segregated account in their own name only, rather than an omnibus account, with no option for re-use of the assets by the receiving institution).

This concept is extended in a secondary Consultation and Policy Paper, which introduces the idea of 'multiple' omnibus pools of client money, potentially grouped by business line. The benefit would be to keep assets from more stable activities separate and therefore more readily resolvable in the event of an insolvency. In practice, the introduction of yet more accounts could add to disputes, further complicating the return of funds.

Structural separation

Various forms of structural separation are being developed or discussed at European Union level and in individual countries such as the UK, US, Germany and France. Although the details differ, the common purpose is to reduce systemic risk in large banking groups by reducing the extent to which retail deposits can be used to fund investment banking activities and more generally the extent to which retail and investment banking can be inter-connected within a banking group; and separation would make it easier resolve a complex banking group and to preserve the continuity of critical retail deposit-taking and related functions.

In the UK, the government has put forward draft legislation to implement the recommendations of the Independent Commission on Banking (ICB). This would ring-fence retail and SME deposit taking in a separate legal entity within a banking group, where at least £25 billion of such deposits are taken. Ring-fenced retail banks would then be more restricted in their ability to undertake derivative and other transactions than under the Liikanen recommendations, although in both cases the precise details remain to be decided. And retail banks would have to hold loss-absorbing capacity of up to 17 percent of risk-weighted assets, in the form of a minimum core equity tier 1 capital ratio of 10 percent and debt instruments that were subject to bail-in provisions.

The French Government published draft legislative proposals for bank ring-fencing in December 2012. Banking groups will have to establish a separate legal entity to undertake proprietary trading in financial instruments and investment in and unsecured transactions with hedge funds. These separate entities could not take insured deposits, conduct high frequency trading operations, or undertake certain transactions in financial instruments linked to agricultural commodities.

Deposit-taking banks could continue to conduct certain own account dealing activities which contribute to financing the real economy, including the provision of investment services to clients, clearing financial instruments, hedging (with the aim of reducing exposures to risks related to their credit or market activities), market making (acting as intermediary), group investment activity (buying and selling securities with the intention of maintaining a durable holding) and treasury activities. These restrictions will apply to larger French banks, the French subsidiaries of foreign banking groups, financial holding companies or mixed financial companies, and investment firms.

Similar plans are also being discussed in Germany. The German Federal Government issued in February 2013 a Draft Bill outlining bank ring-fencing proposals. While the final rules are far from certain, the aim is for the proposals to come into effect from 31 January 2014. Deposit-taking banks will not be allowed to undertake proprietary trading (unless in relation to client-driven business, for example the hedging of positions held with clients), or to undertake loan or guarantee deals with hedge funds or leveraged alternative investment funds. These activities would have to be undertaken in a separate legal entity (which can be part of the same group

structure), and the deposit-taking bank must be sufficiently protected from the risks of the trading entity. These restrictions will apply if the specified investment banking activities exceed €100 billion, or if they constitute more than 20 percent of the balance sheet of a bank whose balance sheet exceeds €90 billion.

All of the proposals attempt in some form to minimize the impact on smaller, simpler institutions. But some challenges have become apparent, and it is not clear how these will be addressed in practice.

- Although interaction between ring-fenced banks and other banks is allowed for the purposes of treasury and risk management, policing this boundary – and ring-fencing more generally – will prove tricky for both banks and supervisors.
- Where and how critical internal operations and infrastructure should sit is another dilemma. Anything other than full replication between the entities introduces potentially de-stabilizing inter-dependencies, but the cost of this option is potentially enormous.
- It remains unclear how these proposals will affect banks' activities outside their home jurisdiction – and this may require significant change to local entities and licenses.

The Liikanen proposals

At the European Union level, the Liikanen Group published its final report on reforming the structure of the EU banking sector in October 2012. The European Commission is consulting on which, if any, of the report's recommendations might be carried forward as EU legislative proposals. The main recommendation in the Liikanen report was that banks' proprietary trading and other significant trading activities (assets and derivative positions incurred in the process of market-making; credit exposures to hedge funds, prime brokers, structured investment vehicles and similar entities; and private equity investments) should be ring-fenced in a separate legal entity. Such trading entities could remain as part of a banking group but could not be funded by insured deposits and could not supply retail payment services.

Meanwhile, deposit banks (banks that use insured deposits as a source funding) could continue to use derivatives for their own asset and liability management purposes, sales and purchases of assets in the liquidity portfolio, basic hedging services for non-banking clients, and securities underwriting. They could also undertake corporate and household lending, trade finance, interbank lending, loan syndication, simple securitizations, and private wealth management and asset management.

Transactions between the trading entity and a deposit bank would have to be on market terms and be subject to large exposure rules on interbank exposures. Both the trading entity and the deposit bank would have to meet independently all the capital requirements under CRR/CRD 4.

This separation of activities would only be mandatory if trading activities are a significant proportion of a bank's total assets or if they are large enough to be of importance to financial stability. The report suggests metrics of (i) assets held for trading or available for sale of at least 15–25 percent of a bank's total assets, and (ii) an absolute threshold of €100 billion of trading assets. These metrics would capture around 20 to 25 large EU banks and some smaller specialist trading banks.

All of the proposals attempt in some form to minimize the impact on smaller, simpler institutions. But some challenges have become apparent, and it is not clear how these will be addressed in practice.

The establishment of a banking union and a single supervisory mechanism is intended to strengthen the euro, by breaking the link (in the future) between a nation's banks and its sovereign debts.

Banking Union in the eurozone

The leaders of the EU member states agreed at their summit in June 2012 that the European Central Bank (ECB) should supervise all of the eurozone's 6,000 banks. The establishment of a banking union and a single supervisory mechanism is intended to strengthen the euro, by breaking the link (in the future) between a nation's banks and its sovereign debts. In countries such as Greece and Italy, governments with weak finances have relied on banks to buy their securities, while in Ireland and Spain the costs of government rescues of failing banks have dragged down their governments' finances.

One purpose of moving banking supervision to the ECB would be to take a tougher supervisory approach to bank financing of government debt and more generally to reduce the likelihood of bank failures through tougher supervision that was less influenced by national pressures.

In addition, the original vision for eurozone banking union included a single resolution fund and single deposit guarantee scheme for the eurozone, thereby introducing a sharing of some of the costs of resolving failing banks. However, a common resolution fund and a common deposit guarantee scheme are not on the agenda for the moment, because of their daunting cost and a lack of political agreement.

In December 2012, EU Finance Ministers reached an agreement in their negotiations over the Single Supervisory Mechanism (SSM), under which the ECB will initially supervise up to 300 of the eurozone's banks from March 2014. These banks meet one or more criteria relating to their absolute size (total assets of more than €30 billion) and to their importance to a

national economy (total assets exceeding 20 percent of the GDP of the member state of establishment, unless these assets are below €5 billion).

The ECB will take on supervisory responsibility for at least the two or three most significant banks in each member state, leaving the supervision of smaller banks to be carried out by national authorities under guidelines set by the ECB. The ECB will also be able to issue specific orders for a country, category of banks or class of risk. Also, any banks covered by the incoming European Stability Mechanism could be put under the direct supervision of the ECB.

Non-eurozone member states will be able to opt-in to banking union. Safeguards have been agreed for member states that do not opt in, in particular with respect to EBA decisions on rules, binding technical standards, and dispute mediation.

Those banks directly affected will need clarity on how exactly the ECB will operate as a banking supervisor, and how it will relate to national supervisors.

Supervision

In addition to the general moves to more intensive and more challenging supervision in many countries, the international regulatory agenda for systemically important banks includes a growing number of specific supervisory initiatives. These include:

More effective supervision of systemically important banks: The FSB has published a series of papers on the effective supervision of SIFIs. These papers indicate where supervisory efforts may be focused over the next few years. The most recent paper, in November 2012, focused on the need for supervisors to:

- Increase their interactions with the Boards of SIFIs;
- Make formal assessments of risk culture in SIFIs;
- Consider whether supervisory efforts have moved too far in concentrating on capital adequacy and controls systems, and whether they need to look more closely at SIFIs' sources of profits and financial data;
- Enhance their analysis and assessment of operational risk (in part because some SIFIs are shifting into private wealth management and related activities); and
- Increase the effectiveness of supervisory colleges.

Risk governance: The FSB launched a thematic review of risk governance in April 2012. This review will focus on Board risk committees, risk management (including the Chief Risk Officer function) and internal audit; and on how supervisors assess the effectiveness of these functions. The first stage of the review was a questionnaire to national authorities on existing regulatory requirements on risk governance and how supervisors

The European Commission has consulted on the risks arising from shadow banking and intends to publish another paper on this during the first quarter of 2013.

assess the effectiveness of risk governance. This review can be expected to result in a set of high level standards for firms, and some guidelines on what supervisors should be doing in this area, especially with respect to systemically important banks. The FSB published a further paper on risk governance in February 2013.

Risk data aggregation and risk reporting: The Basel Committee issued in January 2013 a set of principles on risk data aggregation and risk reporting. One key driver of this initiative was the frustration of supervisors in receiving inadequate (or much delayed) answers from banks in response to requests for information on exposures to risks, which in turn raised questions about how effectively banks are managing their risks and are reporting risks accurately to their senior management and Boards. The 14 principles cover:

- The accuracy, integrity, completeness, timeliness and adaptability of aggregated risk data;
- The accuracy, comprehensiveness, clarity, usefulness, frequency and distribution of risk management reports, including to the Board and senior management;
- The importance of Boards and senior management exercising strong governance over a bank's risk data aggregation capabilities, risk reporting practices and IT capabilities; and
- The need for supervisors to review and evaluate a bank's compliance with the three sets of principles listed above, and to take remedial action as necessary.

G-SIBs are expected to be able to meet these principles by 2016 (with self-assessments beginning this year); and D-SIBs should be able to meet the principles within three years of being designated as a D-SIB. Supervisors may also apply the principles to other banks (and indeed to non-banks) on a proportionate basis.

Shadow banking

Some alternative channels of financial intermediation contributed to the build-up of systemic risks ahead of the financial crisis; and the much tougher regulation and supervision of banks is likely to drive some financial intermediation into less regulated sectors, thereby possibly generating financial stability risks in the future.

In response to this, the FSB recommended in November 2012 new global regulations to contain these risks. The objective of the FSB's work is to ensure that shadow banking is subject to appropriate oversight and regulation to address risks to financial stability emerging outside the regular banking system, while not inhibiting sustainable non-bank financing models that do not pose such risks. The approach is designed to be proportionate to financial stability risks, using as a starting point those institutional categories that were a source of problems during the crisis. The primary workstreams are:

- **Shadow banking and regulated banks' interaction with shadow banking entities** – Efforts here are focused on identifying the types of activity that may create systemic risk and suggesting potential policy responses to deal with each of these;
- **Repos and securities lending** – controversial proposals are being developed for minimum haircuts on assets, alongside more accepted proposals for central clearing and additional reporting; and
- **Securitizations** – codifying emerging national proposals for risk retention of assets issued.
- **Money markets** – strongly contested proposals are being discussed for either a floating asset value for money market shares or the introduction of bank-like capital requirements – and for potential limits on the assets in which funds can invest.

Meanwhile the European Commission has consulted on the risks arising from shadow banking and intends to publish another paper on this during the first quarter of 2013. The responses to the initial consultation indicated growing support for the increased regulation of shadow banking, with banks picking up strongly on the regulatory arbitrage argument here. The European Commission can therefore be expected to work up its proposals under similar headings to the FSB.

We can also expect the Commission to base its proposals as much on the principle of preventing regulatory arbitrage (ie. imposing bank-like regulations on non-banks) as on whether shadow banking poses systemic risk.

Markets

The European Union is taking part in the global initiative to shift the opaque US$700 trillion OTC market off bank balance sheets and into central clearing, so that a central counterparty (CCP) clearing house would absorb losses if either counterparty defaults. The new rules will also encourage the standardization and electronic trading of derivatives, and force nearly all derivatives trades to be reported.

EMIR

These requirements are being implemented in the European Union primarily through the European Market Infrastructure Regulation (EMIR) which was finalized in summer 2012. The European Securities and Markets

Authority (ESMA) has since finalized detailed standards for the trading of derivatives linked to interest rates, currencies, equities, credit and commodities. However, these are subject to final approval by the European Parliament, currently anticipated in Spring 2013, after which the new requirements will be phased in.

The earliest of these will be trade confirmations for all derivatives trades and collection of data for reporting purposes once Trade Repositories are authorised to accept the trade information. However, the likely timeline for authorizing central counterparties and determining instruments eligible for clearing may push initiation of clearing requirements into early 2014.

BCBS requirements

The long awaited BCBS requirements setting out margin arrangements for non-centrally cleared trades had been expected by the end of 2012, but were delayed following major push back from the industry. Many argued that the volume and complexity of the required collateral movement would seize up these markets. As a result, policymakers continue to work towards developing a standard which encourages central clearing, mandates adequate collateral to protect non-centrally cleared trades from major exposure when markets move, but at the same time allows the market to operate effectively as a means of financial risk mitigation.

An important development towards harmonizing clearing standards for OTC derivatives was agreed in December 2012, when regulators issued a joint statement of operating principles and areas of cooperation in the regulation of the cross-border derivatives market. The emphasis was on the need to avoid duplication, conflict or gaps, while acknowledging that legal and market differences will mean that perfectly aligned rules are not feasible. Further work is required before a final framework is agreed.

MiFID/MiFIR

Complementary rules to EMIR in Europe which determine the mandatory execution venue for centrally cleared derivatives may not be introduced until later. These are covered under the review of the Markets in Financial Instruments Directive (MIFID 2), which will result in a revised Directive and a new Markets in Financial Instruments Regulation (MIFIR). The combined documents will set out wide ranging change for the operation of financial markets. They will include new requirements for the type and operation of trade execution venues, as well as extending existing pre- and post-trade transparency reporting beyond equities to new asset classes. Both have been subject to significant objection from industry and may yet be subject to change before rules are final. In addition, new areas are introduced, including enhanced supervision and potential restrictions over high frequency trading and commodities trading.

Alongside these market infrastructure proposals, changes are proposed to the existing investor protection framework, including how clients are classified, documentation supporting assessments of their suitability for particular products, and additional disclosures or possible limits on how intermediaries are remunerated for recommending particular products. Third country access to European markets is also being scrutinized, but efforts to harmonize and intensify standards have been subject to major debate by individual EU members keen to maintain flexibility in how they negotiate and allow these operations.

Financial Crime

Many large investment banks were found during 2012 to have colluded in contributing false rates at which they would agree to lend to one another, in numerous currencies and markets. These rates were then used by market bodies to set the official offer rates referenced in most lending and derivatives contracts, resulting in some banks gaining commercial advantage.

The London Interbank Offered Rate (LIBOR) rate-fixing scandal has led to large fines on a number of international financial institutions. The cost of banks getting it wrong in this way is significant – leading European banks have recently incurred US$5 billion in regulatory penalties, including money laundering fines and LIBOR fines and settlement figures.[13]

Market Abuse Directive/Regulation (MAD/MAR)

The Market Abuse Regulation (MAR) is being amended to outlaw the manipulation of LIBOR and other benchmarks, while boosting minimum fines for insider trading. The proposals include criminal sanctions on anybody found to have manipulated benchmarks such as LIBOR. Although MAR retains the original focus of MAD – to drive more consistent approaches by supervisors to preventing and punishing market abuse across the European Union – minimum penalties will be strengthened and more tightly harmonized across the 27 countries by putting them into a Regulation, which is directly binding, regardless of national laws.

In the meantime, the UK has already taken unilateral action to

The European Union is continuing to push ahead with measures to strengthen the protection of customers and investors in ways that will have far-reaching effects on bank processes and governance.

construct a more independent process for setting benchmarks and subject it to supervision by the FSA (soon to become the FCA), rather than industry self-regulation.

Anti-Money Laundering (AML)

Major failures by global banks in meeting AML requirements are likely to drive additional scrutiny of operational and governance arrangements, in order to ensure compliance. This is an ongoing global development.

FATCA

Banks and asset managers in Europe are preparing for the implementation of a new US law, the Foreign Account Tax Compliance Act (FATCA), with which they must start to comply by January 2014. In January 2013, the US Department of Treasury and the Internal Revenue Service (IRS) released the much-anticipated final regulations. In finalizing the FATCA rules, Treasury and the IRS made efforts to minimize burdens, where possible, and to address the issue of local law conflicts. The key provisions include:

- Harmonization with intergovernmental agreements
- Relaxation of certain documentation and due diligence requirements
- An expanded scope of 'grandfathered obligations'
- Liberalization of requirements for certain retirement funds and savings accounts
- Limited relief for foreign financial institutions (FFIs) – continued transition rule.

The legislation targets tax evasion and requires financial institutions to identify American account-holders. They must deduct a 30 percent withholding tax on American-sourced income from clients who do not reply to inquiries about their nationality.

Because imposition of the FATCA withholding tax would render US investments and the provision of services involving US investments uneconomic, FATCA in effect presents foreign investors and foreign financial service providers with a choice of models. If a foreign investor or financial services provider wishes to participate in or offer services with respect to US markets, it must commit to the transparency required by FATCA compliance. If not, a more localized investment or business model must be adopted.

After a series of negotiations, some governments have entered into agreements with the US authorities on the sharing of information. To avoid breaking European privacy laws, banks and fund managers in Germany, Britain, France, Spain and Italy will have to report details of account holders to their governments, which will then provide the information to the Internal Revenue Service. These governments will not collect withholding tax because the US government will have received the information about clients' nationality.

Banks that operate from several jurisdictions are likely to have to tailor their response to the law depending on where the particular subsidiary is located, such as Spanish banks operating in Latin America. Financial institutions undertaking both banking and fund management will have to decide which part is responsible for compliance or whether they will need to report separately. With the release of the final regulations, banks will have to address a suite of operational issues, to ensure effective data collection and reporting.

Tax

Financial Transaction Tax (FTT)

In the EU, 11 member states have agreed to introduce an FTT. Finance Ministers from these countries have agreed an enhanced cooperation procedure, which allows other nations to join later, if they wish. The application of FTT would be based on the country of origin of the firm or its client, regardless of where the trading takes place – for example, a transaction carried out in London by a German bank would be taxed by the German government.

By extending the scope of assets covered, governments hope to limit any evasion of the tax

The consumer agenda

In October 2011, the G20 called for financial consumer protection to be strengthened by new laws and supervisory agencies to address the issues of fair treatment of consumers, proper disclosure and improved financial education. Addressing consumer risk and ensuring consumer protection is seen to be critical in rebuilding trust in the world's financial services sector. This has been carried forward in part by the development of a set of consumer protection principles by the Organisation for Economic Cooperation and Development (OECD)[14].

The European Union is continuing to push ahead with measures to strengthen the protection of customers and investors in ways that will have far-reaching effects on bank processes and governance.

One key element of the EU's measures is MiFID 2, which aims to improve investor protection and promote better market transparency. MiFID 2

13. Source: Factiva
14. See *Moving consumer protection to the front line, Evolving Insurance Regulation* Page 40, KPMG, February 2012

The capabilities and behaviors of the Board and senior management of banks are now scrutinized much more closely by supervisors.

strengthens requirements on investment firms when conducting due diligence and disclosure to clients; tightens the limits on sales of securities to customers; enhances measures of product suitability for clients and bans commissions paid to independent financial advisers.

Final agreement of MiFID 2 is not expected until Q3 2013. But some member states have been pressing ahead with their own initiatives. For example, in the Netherlands, all commissions paid to distributors, whether or not the sales are advised, will be banned from the beginning of 2013; and in the UK a similar ban will be imposed on all investment advisers as part of the Retail Distribution Review, which came into effect at the beginning of 2013.

Other elements of the EU's measures include:

- Proposed EU legislation on Packaged Retail Investment Products (PRIPs), which focuses on the harmonization of pre-contract disclosures and rules for selling investment products. Investment product providers will be required to produce standardized disclosure documents for products sold to retail investors;
- A revised Insurance Mediation Directive (IMD 2) and the coordination of laws relating to Undertakings for Collective Investment in Transferable Securities (UCITS 5), which together aim to increase consumer protection through greater transparency, harmonized and enhanced sales practices and changes to incentives; and
- The European Securities and Markets Authority is looking closely at the protection of consumers, developing training standards for the industry and contributing to the enhancement of common disclosure rules.

The European Supervisory Authorities (ESAs) announced in their January 2013 Joint Committee Work Programme that they will prioritize consumer protection throughout 2013, focusing on three core work streams: consumer protection; product oversight and governance; and retail products – which incorporates the proposed EU legislation on Packaged Retail Investment Products (PRIPs). The Sub-Committee on Consumer Protection and Financial Innovation will facilitate work on selling practices and conduct of business applying to PRIPs, to ensure appropriate convergence and consistency.

Governance, remuneration and culture

Strengthened corporate governance is seen as an important way to improve the safety and soundness of banks; to improve the treatment of their customers; and to restore trust in banks. The capabilities and behaviors of the Board and senior management of banks are now scrutinized much more closely by supervisors. The supervisory initiatives described above on risk governance and on risk data aggregation and reporting are also part of this picture.

In the European Union, additional requirements on governance have been included in the proposed CRD 4 and MiFID 2 Directives. These include new requirements on the Board to take responsibility for strategy, risk, internal governance and the effective oversight of senior management; and to establish effective risk, nomination and remuneration committees. Non-executive directors are required to devote sufficient time to performing their duties, with specific limits imposed on the number of directorships that may be held by an individual. The functions of chairperson and chief executive should be separated. These measures should go some way in strengthening how banks are run – and will require considerable work by the institutions to improve their governance.

Supervisory focus on remuneration in banks continues. In part, this is a continuation of the focus on the remuneration of senior bankers that has been under way since 2009, with the focus on setting variable remuneration on the basis of risk-adjusted and long-term returns, and employing a number of techniques to link variable pay more closely to performance, to defer payment, and to allow for claw-back.

The supervisory focus on remuneration is also beginning to consider the appropriateness of incentives for less senior staff, particularly where this could have an impact on potential mis-selling.

Finally, supervisors have begun to focus more on the culture of banks. There is a growing recognition that one key driver of poor decision-making ahead of the financial crisis, and of successive mis-selling episodes and other scandals in both retail and wholesale banking, was poor cultural standards in many banks. These, in turn, translated into poor standards of behavior. However, embedding a culture more focused on customers and risk management, rather than on risk-taking, is proving challenging. Banks and their supervisors are considering how different cultures can be established and then reinforced through the interaction of accountabilities, measures and incentives.

Abbreviations

BCBS	Basel Committee on Banking Supervision
CASS	Client Assets Sourcebook
CCPs	Central Counterparties
CET1	Common Equity Tier 1 Capital
CFPB	Consumer Financial Protection Bureau
CFTC	Commodity Futures Trading Commission
COREP	Common Reporting Framework
CRD 4	Capital Requirements Directive 4
CRR	Capital Requirements Regulation
D-SIB	Domestic Systemically Important Bank
EBA	European Banking Authority
EDTF	Enhanced Disclosure Task Force
EMA	Europe, Middle East and Africa
EMIR	European Market Infrastructure Regulation
ESAs	European Supervisory Authorities
ESMA	European Securities and Markets Authority
FATCA	Foreign Account Tax Compliance Act
FDIC	Federal Deposit Insurance Corporation
FCA	Financial Conduct Authority
FFI	Foreign Financial Institution
FSA	Financial Services Authority (UK)
FSB	Financial Stability Board
FTT	Financial Transaction Tax
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
ICB	Independent Commission on Banking
IFRS	International Financial Reporting Standards
IHC	Intermediate Holding Company
IIF	Institute of International Finance
IMF	International Monetary Fund
IRS	Internal Revenue Service
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank Offered Rate
MAD	Market Abuse Directive
MAR	Market Abuse Regulation
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MSP	Major Swap Participant
NSFR	Net Stable Funding Ratio
OECD	Organisation for Economic Cooperation and Development
OTC	Over the Counter
PPI	Payment Protection Insurance
PRA	Prudential Regulatory Authority
PRIPs	Packaged Retail Investment Products
RDR	Retail Distribution Review
RRD	Recovery and Resolution Directive
RRP	Recovery and Resolution Planning
RWA	Risk Weighted Assets
SEC	Securities and Exchange Commission
SD	Swaps Dealer
SIFIs	Systemically Important Financial Institutions
SIBs	Systemically Important Banks
UCITS	Undertaking for Collective Investments in Transferable Securities
XBRL	Extensible Business Reporting Language

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