Mphasis
Unleash the Next

PRUDENTIAL REGULATIONS AND REGULATORY COMPLIANCE

To overcome the current challenges for a global bank

A Point of View

By Shuvo (Subhabrata) G. Roy
AVP & Lead - Solutions (EMEA) - Banking & Capital Markets

Contents

Introduction 3
Prudential Regulations 4
Capital 4
Liquidity 3
Risk Management 5
Overcoming some of the Challenges with Regulatory Compliance 5
Cultural Shift 6
IT Systems 7
Data 7
Integrated Portfolio Strategy 8
Analytics 8
Conclusion 8

Introduction

As the heat of regulatory scrutiny and policymaking continues through 2013, the financial services industry struggles to wade through the most challenging times in decades. While the systemic uncertainty of 2008-10 is now well behind us and policymakers and central bankers around the world seem to have agreed on the fundamental framework of emerging regulations of the 21st century, designing individual regulations and determining their practicability in the current banking environment is becoming a major challenge. This is especially true in light of the extremely complicated ownership structures of large, transnational banks and the nature of their business in an increasingly globalized world. Add to that the generally depressed markets (with some of the largest Eurozone economies still struggling to stay out of recession), and it won't take a genius to understand why the average return on equity for the banking industry has stayed considerably low over the last few years, and shows no signs of any significant improvement either.

The fundamental principle behind the G20 recommendations in the aftermath of the financial crisis was the creation of a sound banking system through a set of measures involving capital, liquidity, risk management and governance. In the years that followed, a wave of regulation was enacted and implemented in the different geographies impacting every single bank in every conceivable way. While some of these were thematic, involving only certain parts of business, others were extremely comprehensive and exhaustive, impacting nearly all critical facets of financial services. It is this latter category that is now emerging as a major challenge to bankers and regulators alike; as defining the various aspects of the proposed changes and designing meaningful and practicable regulations proves to be an arduous and intensive task. To site an instance, in the US, out of the 398 required rules issued in Dodd-Frank Wall street reform Act, just over 160 have been finalized as debates and consultation continue over the rest. Across the Atlantic the situation is quite the same as Brussels continues its debate over the Liikanen Commissions report with no clear agreement between member states on the applicability, scope or timelines of enacting legislations. Even in the United Kingdom, the Independent Commission on Banking (Vickers) report is still being debated in the parliament and at various other levels. Banks and financial institutions, already stretched by the sudden rise in regulatory demand, are now finding it increasingly challenging to cope with this low regulatory visibility.

Regulatory compliance requires investment of time, resources, efforts and most of all, management bandwidth. In the current environment, non-compliance might invite penalties that can cause a substantial dent in a bank's profitability along with the reputational damage and negative publicity it creates. Together, these can have profound long-term impacts on a bank's viability. Hence it is critical to understand the true nature of the challenges faced by the banks in the new global regulatory regime.

Prudential Regulations

For an industry that is at the core of any economy, it is important that the right set of regulations are developed and employed to guide and govern banking. Banking regulations have evolved over the years through a process of continuous improvement – often through the time-tested progression of a ‘best practice’ getting adopted as ‘prudential norm’ and eventually being drafted as ‘regulation’. The organic nature of these regulations has ensured that they are well balanced through their evolution, taking into consideration every possible impact to business.
The regulations designed in the aftermath of the crisis, however, were instituted to tackle widespread decay in lending practices and unjustified exposure in complex, layered and risky assets. To that extent, they were reactive in nature.

Some of these regulations can be broadly classified into:

Capital

The G20 recommendations focused on capital in a major way. While the Basel Committee on Banking Supervision (BCBS) had been legislating matters relating to computation of economic capital for more than a decade, it was evident in the wake of the financial crisis that more needed to be done, and quicker. In light of this, regulators spent the lion’s share of their effort scrutinizing current capital structures and opining on the changes needed in the quality and quantity of capital employed. Basel III recommendations formed the overarching global framework for the new ‘core capital’ requirements, paving the way for ‘capital buffers’, more in the nature of contingency capital that should be maintained and additionally called-in, at times of heightened perceived risks to the system. In the US, The Dodd-Frank Act and The Financial Stability Board both mandated capital requirements, with the latter prescribing capital surcharges of 2.5% over and above the Basel III recommendations to Systemically Important Financial Institutions (SIFIs). Across the Atlantic, the European Commission promulgated CRD IV, which according to the commission, contextualizes Basel III recommendations to European banks in a more practicable manner.

The new capital requirements regime has particularly hit the large global banks (SIFIs) hard. Firstly, their global presence has meant they would be required to meet the regulatory objectives of different geographies. Their complicated holding structures have only compounded that problem. Further, the definition of economic capital is still not a global standard with some countries (such as Switzerland) requiring their SIFIs to bring in more core capital. Amidst all this, the dampened macro-economic factors have ensured that banks in the mature western markets are struggling to raise capital to meet the new requirements, resulting in revisions of the timelines prescribed for compliance. The gap is most significant in Europe and least in Asia.

Asian and Canadian banks have emerged relatively unscathed from the financial crisis. While most of these banks were well capitalized and continue to be so, it appears that a more prudent set of lending and investment principles saved the day. In the end, no amount of capital is enough to sustain continued investment in low grade assets and the current situation in Asia seems to underscore that fundamental principle.

Liquidity

One of the key elements behind the major problems in 2008 was the sudden lack of liquidity in the financial system that caused a significant mismatch in servicing immediate maturities, resulting in lack of investor confidence and consequent failure. While capital has always been the central theme of banking supervision and regulation, liquidity was not, surprisingly, at the top of the agenda. The events of 2008 emphasized the need of sound practices in liquidity management amongst even the most solvent banks.

Banks have traditionally relied on matching maturities in the near-term through cost-effective, short-term borrowing. While this kept the cost of borrowing low, it contributed to increased volatility as the nature of these deposits makes them susceptible to sudden demand. Further, the reporting systems in treasury departments have not been optimal, with data sitting across the organization and liquidity positions not being aggregated in the most efficient manner on a daily basis.

To address these and other imminent challenges, the BCBS stipulates various measures in the Basel III recommendations. The Liquidity Coverage Ratio (LCR) mandates banks to hold sufficient liquid assets of prescribed quality, to cover a continuous loss of retail deposits for 30 days. The other cornerstone of liquidity regulations – the Net Stable Funding (NSF) ratio seeks to eliminate large scale mismatches in maturities through financing of longer term assets by adequate longer term deposits. The definition and weighting of long term assets has been debated widely and significant items brought under its purview, include a proportion of the off-balance sheet items, mostly used by C&IB departments.

The liquidity ratios seek to contain the appetite for undue exposure to liquidity risk through measures that will encourage or mandate borrowing over a longer term, thereby increasing the cost of funds and consequently impacting the pricing of assets. While the framework provides the best way to mitigate risks in general, a segment in the industry suggests that its practicability for Asian banks needs to be reviewed, since quite a few of these countries do not have a funding market as mature as their western counterparts. This will mean that Asian banks might feel the pinch harder than their western counterparts while they were not necessarily the cause of the problem. Also, the 30 day coverage of retail deposits in LCR has been the subject of some debate, as segments of the industry believe that realistically, the number of days should be lower. The argument put forward is that once investor confidence is eroded (resulting in mass withdrawal of deposits), it doesn't usually continue for 30 days. A decision needs to be made much quicker than that. In such cases, maintaining proportionate amounts of liquidity reserves and low return instruments through more solvent times will only create undue cost pressures on BAU cost of operations. Further, it is difficult to arrive at a predictive withdrawal figure for 30 days in a volatile scenario. Pressure builds on significantly as the 'run' starts and numbers could vary widely day-to-day.

Risk Management

A lot is being said, done and debated about risk management practices. From collateral to counterparty concentration, every bit of the road is scanned for possible potholes. Remediation actions range from cautious

oversight to outright ban of certain type of operations, as evidenced in the Volcker Rule. While most of the outcome is predictable, some rely on concepts that are new and novel. An atypical instance of transfer and delegation of risk is noted in the AIFMD – The Alternate Investment Fund Managers Directive, a directive by the European Union for alternative investment fund managers either domiciled or distributing their funds within the Union. Aimed principally at investor protection, AIFMD has been brought forward in the wake of the crisis, along with multiple other new regulations formulated by the newly constituted ESMA.

The AIFMD applies to all fund managers with some minor exceptions for managers managing funds below a certain threshold. Significantly, the AIFMD seeks to redefine the relationship between fund managers and depositaries (custodians). In its Level 2 Delegated Acts Regulation (L2), it lays down strict requirements for appointment, responsibilities and liabilities of depositaries. Some of these provide a shot in the arm to the custody business, such as mandating all AIFMs to appoint a single depositary for each fund by the end of 2015 (2018, if passporting deadline is extended). However, the regulation also brings in enormous amount of responsibility to depositaries for the performance of the sub-custodians they appoint, causing them to be directly liable for any losses incurred by the fund manager owing to the negligence of the depositary's delegates.

Sub-custody is a necessary function, primarily because nuances of local markets may be varied and a global custodian usually finds it extremely difficult to compete with local players in emerging markets, given their unique cultural and regulatory complexities. Considering the fact that quite a few of these relationships extend in markets susceptible to relatively higher levels of volatility, the appointment of sub-custodians is treated with utmost care. Thorough risk assessment and diligence is exercised in ongoing transactions between a global and sub-custodian as a matter of industry best practice. Despite these, the global custodian is in no position to monitor the financial health of the sub-custodian in its entirety. Thus, in the new regime, it becomes challenging to operate as a designated depositary of an AIFM, except for situations where all parties have agreed in writing to transfer liability for lost assets to the sub-custodian.

Overcoming some of the Challenges with Regulatory Compliance

The debate around regulations is endless. As the above would have indicated, each new regulation brings with it a completely new set of challenges for banks and financial institutions. While the aim in the longer term is to establish a healthy and risk-free marketplace for financial transactions, in the near-term it means that a lot of investments are to be made, thus impacting the cost of doing business in the global financial markets.

To well appreciate the element of costs, one has to focus on what it might mean to be non-compliant. In the modern day business environment, being non-compliant is not an option – it means certain and inevitable extinction. Regulatory activity has peaked since the dark days of 2008. According to data revealed by the committee on Capital Market Regulation, the total value of regulatory fines imposed and public class action settlements

against financial institutions has risen from $431 Million in 2007 to $30 Billion in 2012†. The situation looks grimmer in 2013 with $21.8 Billion in public settlements and fines imposed in the first quarter* with the estimated LIBOR manipulation fines alone totaling to over $2.6 Billion.

Certainly non-compliance is not a matter of choice. But can you leave it to chance? History responds negatively to that as well. Banks now need to be ahead of their times just to avoid being trapped on the wrong foot. In the era of rising budgetary cuts and high costs of customer acquisition, this is not music to anyone.

While the dust on regulatory uncertainty settles, there are a few things banks can do to stand in good stead. It is worth visiting some of these below.

Cultural Shift

Compliance is not an external demand anymore. It is a way of doing business to adjust to the modern day complexities of life. Arguably, the cultural context to this has not set in completely as yet. Financial services is one part risk and the other part perseverance. History will lead us to numerous situations where the frivolities of one person's risky behavior has overshadowed and annulled the efforts of a thousand diligent executives. Banks cannot risk non-compliant attitudes anymore. The transition is tough and arduous but needs to be facilitated through right hiring, training and above all, executive engagement. The emergence of the role of Chief Risk Officer is a welcome development in that direction, though it remains to be seen how boards empower that role and how much of that empowerment is engaged constructively to benefit the business.

IT Systems

Put your money where your mouth is! Over the years, banks and financial institutions have spent billions of dollars building fancy trading systems that can probe the market in nanoseconds to get the best available deal or even mislead other algorithms to win a coveted spread. Those days are behind us – at least for the immediate future. Banks now need to revisit the fundamental precepts to stay ahead of the mounting challenges of compliance. Some of the key elements that need to be looked at include:

Data

Data is integral to any business and most critical to financial services. The amount of data created in a day and transacted within a large global bank is humongous. It is thus extremely critical to stay on top of the ocean of data that a bank floats in. Having the right data about a transaction and customer, in the right context governs the ability to identify a suspect transaction and subsequently report it. The exercise is not trivial by any means. A comprehensive data governance program includes robust enterprise data architecture, superior master data management and a continuous process of cleansing data to achieve a common view of risks and exposures on customers across the enterprise. Auditability is key and any touch-point must be clearly identified and closely monitored to ensure that what goes into systems is what actually should.

While large-scale, enterprise-wide data re-architecting engagements can be challenging and time consuming, data definition exercises through Semantic Modeling can offer a relatively uncomplicated but longer lasting solution.

Integrated Portfolio Strategy

An integrated IT portfolio with lesser reliance on a componentized, silo approach is the key to successful compliance. Large banks often suffer from fractured IT organization and systems with more than one application providing similar functionalities across different lines of business. This causes unnecessary complexities in information processed and generated by the enterprise. Wherever possible, banks must reduce complexity in structure and move towards strategic sources of functionality for transaction execution.

Analytics

Large amounts of real-time data pose a significant challenge to banks. On one hand, the regulatory demands on AML and proliferating sanctions are squeezing every inch of extra bandwidth to identify suspect transactions and stop them from being executed. On the other hand, business is demanding higher customer engagement through more effective cross-sell and upsell while the customer is still within the transaction. Predictive analytics provides ways and means of identifying prospect and suspect transaction, thereby facilitating adherence to external and internal demands.

Advanced analytics can also be successfully deployed in the larger corporate context of managing counterparty exposures or liquidity risk reporting in real-time.

Conclusion

Events of the last decade have irrevocably changed the world we live in. The financial services sector is arguably the most highly regulated industry with thousands of regulators worldwide attempting to monitor every single transaction that is posted. The global financial crisis and resultant public scrutiny has damaged the reputation of the industry to a large extent, and government intervention to bail out large, household brands has taken the debate around banking beyond the branches and into the parliaments and senates of the world. While the world will not change its opinion in a hurry, banks are willing to change themselves to better adapt to the times and the needs of the customer and regulators. As regulations evolve over the next few years, banks and financial services organizations will need to transform themselves in line with the demand of the times to emerge winners in the eventual race. Technology will play a major role in that journey, and it is time to take it to the next level.

© Subhabrata Guha Roy

†Source: PRNewswire release Mar 15, 2013

*Source: Quarterly Financial Penalties Data, CCMR

About Author

Shuvo (Subhabrata) G. Roy
AVP & Lead - Solutions (EMEA) -
Banking & Capital Markets

Shuvo G. Roy has spent over 15 years in the Financial Services industry, working with some of the leading global banks and stock exchanges across a broad spectrum of Corporate and Investment banking products.
An astute Operations and Technology specialist, Shuvo specializes in designing and managing large transformation programs that address critical industry challenges. Shuvo holds an MBA in Finance and leads Banking & Capital Markets Solutions for EMEA & APAC at MphasiS.

About Mphasis

Mphasis is a $1 billion global service provider, delivering technology based solutions to clients across the world. Mphasis services clients in Banking & Capital Markets, Insurance, Manufacturing, Communications, Media & Entertainment, Healthcare & Life Sciences, Travel & Transportation, Hospitality, Retail & Consumer Packaged Goods, Energy & Utilities, and Governments around the world. Our competency lies in our ability to offer integrated service offerings in Applications, Infrastructure Services, and Business Process Outsourcing. To know more about Mphasis, visit www.mphasis.com.

For more information, contact: marketinginfo@mphasis.com

USA
460 Park Avenue South
Suite #1101
New York, NY 10016, USA
Tel.: +1 646 424 5145
Fax: +1 212 683 1690

UK
88 Wood Street
London EC2V 7RS
UK
Tel.: +44 20 8528 1000
Fax: +44 20 8528 1001

INDIA
Bagmane World Technology Center
Marathalli Ring Road
Doddanakundi Village
Mahadevapura
Bangalore 560 048, India
Tel.: +91 80 3352 5000
Fax: +91 80 6695 9942

VB 24/03/14 Letter

www.mphasis.com

Copyright © Mphasis Corporation. All rights reserved. 06/13 A4 GB