WHITE PAPER

Coming Soon: The Future of Banking Regulations

Close on the heels of the Great Recession, a tsunami of unprecedented regulatory reforms hit Banks the world over. Today, even as the world is trying to move forward, it still remains unclear if the reforms achieved their objectives or if banks have become more risk-aware with better control & governance structures in place.

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> *"We can't fight the federal government if that's their intent".*

As the US economy shines through as one of the few bright sparks in the world today, Banks in the US are still struggling to deliver the returns on capital that shareholders have been expecting. In fact average return on equity for the large banks has fallen from 17% in 2005-07 to 9% in 2011-13 with high volatility making it even worse. Regulatory compliance costs, restrictions imposed by the Dodd Frank Act, higher capital demands imposed by Basel III, stricter liquidity & leverage requirements have all weighed down heavily on banks to the extent that many banks are today considering changes in their business model and exiting certain markets. Jamie Dimon, the CEO of JP Morgan Chase, went on record to say "We can't fight the federal government if that's their intent".

Regulators seem to be going down the path of more and more of everything as banks face multiple regulatory reforms simultaneously from international as well as domestic agencies. There is also evidence now of growing inconsistencies and divergences across countries, as local regulators pursue their own parallel reforms.

In the US, banks are expected to have minimum capital ratios even after the impact of severe stress tests and American regulators are pushing for liquidity and leverage standards that are tougher than Basel III. The Basel Committee's guidelines on Liquidity Coverage Ratio were finalized a few years ago but in the US, the Federal Reserve Governor Daniel Tarullo has proposed that banks with substantial wholesale funding should hold additional capital. In the UK, the PRA has hinted at stricter liquidity requirements for large banks. Similarly, Switzerland, the US and the UK have set a minimum leverage ratio above 3 percent, which is what Basel recommends.

Since the crisis, banks with less diverse product and geographic footprints have outperformed large global banks further adding fuel to the debate if regulators have finally succeeding in containing the 'too big to fail' banks. The key question before us now is – what is going to be the future of banking regulations given the initial results of extensive reforms already undertaken?

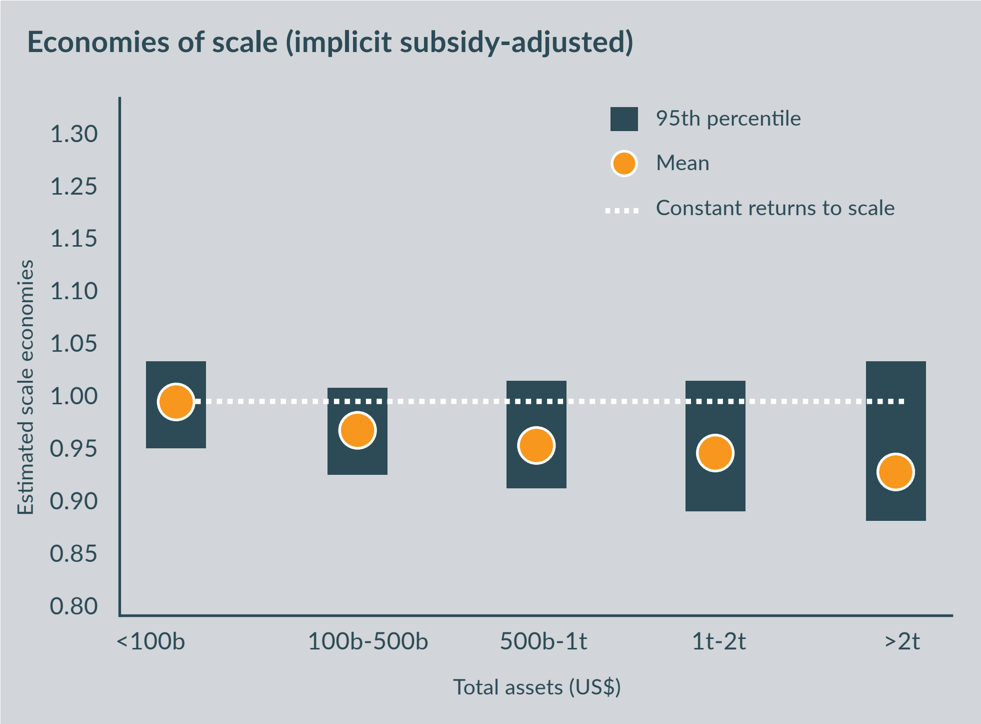
Factors Driving Banking Regulations

To understand what the future of banking regulations might look like, let's analyse the key factors impacting regulations -

- Changes in the Banking and Financial Services Sector
- Data Explosion & Data Management
- Technology Advances
- Consumer Expectations

Changes in the Banking and Financial Services Sector

Many banks have begun moving towards leaner and more flexible business models that focus on a well-defined set of customer segments as low growth in most geographies offers fewer growth opportunities and with no signs of deceleration in the regulatory agenda worldwide. There is evidence of diseconomies of scope & scale within large universal banks driven by tougher regulations focused specifically on such banks:



Source: Capital IQ, Bank of England calculations

An Ernst & Young analysis estimates that universal banks reported average ROEs of around 7.5 percent in 2013, while large banks with less diverse business had an average ROE of around 10.7 percent. Each bank will therefore need to evaluate where its competitive advantage lies and structure its business accordingly. As the growth of shadow banking globally shows, there is a lot of scope for new offerings focused on unmet needs. Banks will need to identify newer offerings accordingly that leverage their own competitive advantages to protect and grow their revenues.

Data Explosion & Data Management

The Banking and Financial Services industry's weak and inadequate data aggregation systems were starkly exposed during the financial crisis when regulators demanded risk and exposures data and many institutions were unable to comply on time. Implementation of Basel II did not result in strong, unified data aggregations as credit and market risk related data remained in different silos. Data warehouses typically focused on credit risk & finance related data whereas market risk data would often reside separately. However, with the liquidity requirements in Basel III, there has been a push towards combining different silos.

'Principles for effective risk data aggregation and risk reporting' was published in January 2013 and aimed at strengthening risk data aggregation and risk reporting practices at banks. However, as the progress summary published in January 2015 notes, many banks are expected to seek an extension of the January 2016 deadline. This is a key area of focus for regulators as multiple regulations have failed to rectify the underlying problem of faltering data governance structures at banks.

In the last few years, the data explosion that we have witnessed has only compounded this problem. This explosion is actually a result of the 3 Vs of data – Volume, Variety & Velocity. While it has made data management more challenging, banks that take the lead in investing in their data would ultimately reap the benefits. Suffice to say that data indeed is the 'new oil'.

People need banking, but do they need banks?

Technology Advances

People need banking, but do they need banks? This is a question folks in the Silicon Valley are asking because they believe banks are doing too many things and that brings in inefficiencies. Crowd funding, peer to peer lending, new domestic & international payment mechanisms, data science based lenders – are all trying to eat the traditional bank's lunch. Companies like LendingClub and Prosper are making credit lending a virtual marketplace, others like Zest Finance and Earnest are leveraging technologies like Big Data to build banks of the future while companies like Remitly are providing cheaper international remittances. Marc Andreessen, partner of PE firm Andreessen Horowitz, sums up the situation nicely, "It's all about unbundling the banks. There are regulatory arbitrage opportunities at every step of the way. If the regulators are going to regulate banks, then you will have non-bank entities that spring up to do the things that banks can't do". Banks will have to compete more and more with some of these companies while partnering with some others, to get access to technology and offerings which are not their strengths.

Customers today expect 'Uber-like' service from banks whenever, wherever, however they want.

Consumer Expectations

Customers today expect 'Uber-like' service from banks whenever, wherever, however they want. They also expect a seamless and consistent experience across channels. For banks that would mean having an integrated strategy in place connecting customer interactions across branches, mobile apps, website, social media and phone banking. This is going to be a key challenge in the near future for most banks. Moreover there has been a gradual erosion of customer trust in banks over the last several years and there's a steady rise in expectations for banks to be more customer-focused.

The Future of Banking Regulations

Regulators globally have an unenviable task at their hands as they move ahead with their agenda to build a safer, more secure banking system. If they go down the path of excessive capital requirements, it will only be self-defeating as it will encourage shadow banking and originate-to-distribute models. It will also slow down the economic growth with higher interest rates at a time when most of the large economies are struggling to recover from the aftermath of the recession.

The future course of banking regulations would ultimately be determined by how various complex factors like the ones discussed above pan out. However, we can reasonably expect the following:

- Regulators will continue to pursue their reform agenda. As was seen in the aftermath of the recent crisis, there were deep, embarrassing weaknesses across the board in the banking sector and fixing these is a long-term exercise. Banks are likely to face higher liquidity requirements, higher minimum-leverage ratio, restrictions on the use of internal models and a tougher approach to stress tests.
- Going forward, enhanced disclosures would be a key item on the regulatory agenda as they encourage banks to implement the Enhanced Disclosure Task Force (EDTF) recommendations. Banks will be encouraged to disclose results of applying their models to hypothetical portfolios, disclosing both modelled and standardised calculations; how risk weighted assets are calculated and additional details about their portfolio, the impact of internal models on regulatory capital and publishing of additional metrics such as revenue-based leverage ratios and the ratio of non-performing assets to total assets. Banks will have to submit regulatory reports at a higher frequency with increasingly more granular data being reported.
- Globally, there are increasing concerns about banks' internal modelling and the accuracy of the resulting risk weighted assets. In the near term, we can expect new restrictions on banks limiting the advantage provided by internal models. Regulators might also impose limits on how much risk weights based on internal models can diverge from risk weights prescribed by the standardised approach.
- There is a growing debate on the ever-increasing complexity of regulations especially when all the regulatory initiatives are considered together. There have been calls for more

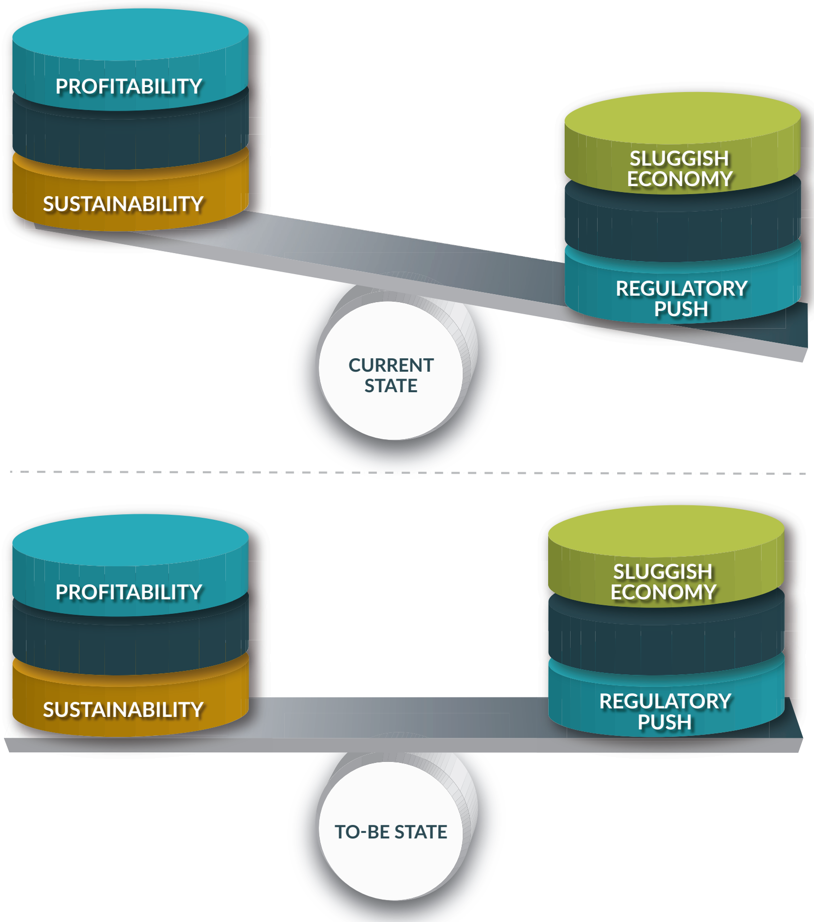
simplicity by Thomas Hoenig in the US and Andrew Haldane in the UK amongst others. The Basel Committee also published a discussion paper on balancing risk sensitivity, simplicity and comparability in July 2013. However, these are likely to have only long-term impacts like more focus on leverage ratios as compared to internal model driven regulatory capital or stressed capital.

- We will continue to see more and more of risk-based supervision. Banks can expect higher scrutiny if they have overly complex structures or high-risk products.
- Globally regulators are at different stages of the regulatory agenda with multiple domestic regulatory reforms being pursued. In the medium to long term, we can expect greater coordination amongst central banks with greater focus on harmonizing regulations globally to ensure consistent application, thereby eliminating any scope for regulatory arbitrage.
- As new age non-traditional financial service providers as well as new technology players increase in size, regulators will start focusing on them. This could probably lead to a follow-up wave of regulatory reforms.
- Security, privacy and consumer protection will be focal issues as banks expand their digital strategies and increase their presence in social media with new technologies such as Big Data playing a key role.
- In terms of a structural reorganisation globally, separation of retail businesses from riskier investment banking activities will continue to be a priority.

The 2007-09 phase has perhaps changed the regulatory environment forever. As regulations evolve and banks globally aim to regain customer confidence, the next few years will also see a lot of innovation while banking as an industry expands in its purpose and scope. However, the impact of the regulatory agenda will continue to be far-reaching and would play a key role as banks globally re-shape their business models.

How Can Banks Prepare

Banks today have the challenge to not only prepare for ever-increasing regulatory expectations, but also to protect and increase their market share. This will require multiple initiatives in different areas and banks that plan ahead will be the ones to get it right.



Banks will require a well thought through and comprehensive compliance approach that is completely integrated into their corporate strategy. Dealing with regulation in a piecemeal fashion will only be more costly, besides being inefficient. The right direction would be to have a holistic plan that addresses all regulations as one, while leveraging the investments to derive business benefits.

If regulators have greater confidence in a bank's risk data aggregation infrastructure and underlying reporting capabilities, the whole regulatory compliance process can be less challenging. Therefore, Financial Institutions that use data and advanced analytics to meet regulatory requirements, to develop insights to meet customer needs, to analyse product-level profitability, to understand customer movements across channels and ultimately build appropriate business models, will eventually emerge victorious.

Banks will also need to put in place risk & control structures that ensure the right checks and balances. This will have to be accompanied by a strategic talent plan that focuses on nurturing and acquiring the right skills as compliance would not be limited to just the compliance department, but would instead be an organization-wide drive.

More importantly, in the long run banks will need to foster a culture that encourages innovation while being more risk-aware.

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About Fintellix Solutions
(formerly iCreate)

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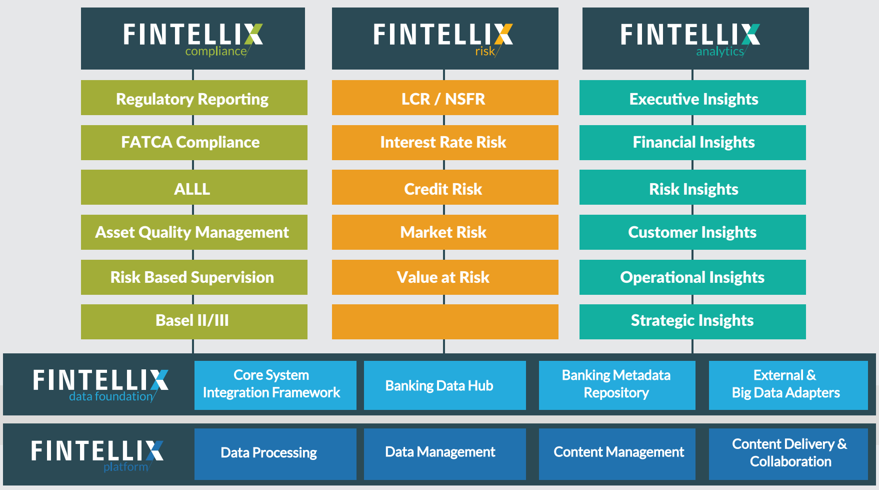
Fintellix Modular ARC Solutions on an Integrated Platform



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