

The Challenge of Regulatory Implementation

A Strategic Approach



High performance. Delivered.


accenture

consulting | technology | outsourcing



The global banking industry is facing challenging times.

Many of the sources of revenue that sustained a banking boom that lasted from the 1990s until the banking crisis of 2008 have largely disappeared, and with it the heady days of double digit ROE. The near-meltdown experienced by many large global and investment banks in 2008 and 2009 was a significant turning point for the industry. Despite banks' best efforts, returns show no signs of returning to their former levels.

The financial crisis—coupled with the determination of regulatory authorities not to put taxpayers on the hook for another round of bailouts—has led to a proliferation of new regulatory measures. Indeed, the scale and pace of banking regulatory change is unprecedented. Large banks must deal with multiple jurisdictions and multiple timetables for new regulations. There are higher penalties for non-compliance and the regulations themselves often reflect a new tone of public and political opposition to banks.

In the main, banks have not shown themselves to be well-positioned to respond to these challenges. Many banks have engaged in cost-cutting initiatives, but few have made the material structural changes needed to operate profitably in this new environment. Effectively addressing these complex and interrelated challenges will be central to banks' ability to regain and maintain high performance.

Regulation is one part—albeit a major part—of the challenge facing banks. We believe that, for banks and other financial institutions to achieve high performance in the years to come, they must address three significant challenges in parallel:

1. Increasing profitability and lifting returns on equity;
2. Simplifying infrastructures that are too complex and costly for current operations; and
3. Effectively implementing far-reaching and complex new regulations

We will examine each of these and discuss how a strategic approach to regulation—the most visible and pressing of these three concerns—is a critical lens through which the "problem statement" should be viewed to assist banks in examining the future operating model options which will need to be simpler, less capital intensive and customer focused to enable the required levels of returns on shareholders' equity for the long term. Financial institutions' response to regulatory initiatives needs to continue beyond compliance (although compliance remains as important) to encompass a strategic vision for establishing sustainable, profitable growth.

1. Increasing profitability and lifting returns on equity

While regulatory initiatives multiply, the underlying environment for banks is anything but welcoming. From 2000 to 2007, the developed economies' top-performing banks had an average return on equity of 26 percent.¹ Today, many of these same banks are looking at returns in single digits; as a result we are seeing dramatic shifts in the banking landscape—for example some are looking for strategic partners and others are seeking to exit businesses that are no longer sustainable or profitable.

With future revenue and return on equity levels uncertain—and former revenue generators such as structured products or proprietary trading curtailed—banks have smaller balance sheets, less leverage and fewer opportunities for potentially profitable risk-taking.

Dangers lurk in the marketplace, as well. The strains on the Euro Zone and fears of a European recession; concerns about a hard landing for the Chinese economy; the movement of the center of gravity of the investment banking business to Asia; and increased competition from traditional and non-traditional players all affect short-term returns and contribute to persistent fear, doubt and unwillingness to make investments for the longer term.

Capital remains a major concern, tied closely to regulatory demands for larger reserves, but also to banks' desire to protect themselves in the event of unforeseen difficulties. Yet, while banks seek to raise capital on one hand they also struggle with complex, cumbersome organizational structures and accompanying high costs, coupled with unresponsive internal capital management processes. Both of these forces work against profitability, with high levels of capital reducing leverage and high infrastructure costs adding to the imbalance of the ROE equation banks are trying to solve.

2. Simplifying infrastructures that are too complex and costly for current operations

In the growth years banks rarely had to focus on operational efficiency. Financial institutions which operated for years with high margins and strong returns have had little reason to worry about efficiency. Frequently, new businesses would be started quickly with limited supporting infrastructure; the infrastructure would have to catch up as the businesses grew. As banks added organizational complexity, people, operational procedures, systems and data flows to cope with growing, new and constantly changing businesses, it has now become increasingly difficult to scale down to support smaller, more nimble and more focused entities.

If we look back over the years 1990 to 2008 we see that multiple mergers and acquisitions added to banks' size and complexity. This complexity has two major effects on banks' performance; first, it reduces the flexibility and responsiveness required in today's market, and second, it leads to stubbornly high costs. High revenues masked this complexity problem, but, as revenues have fallen, these issues have come to the fore. Banks have realized that their ability to scale upwards in the good times has not been matched by the ability to scale downwards in leaner times—especially at a pace which matches the movements in their level of performance.

These financial institutions are coming to grips with a new reality: Their infrastructure and cost base must be re-sized for leaner operations. Organizations that have entered new businesses have added new processes without integrating them into a comprehensive framework. There have been high levels of redundancy, manual intervention to address for differences in timing and approach, and adjustments after the event to restate outputs due to complex information flows. Banks and other financial institutions have had to cope with significant data quality issues leading to significant amounts of rework and problems with accuracy and timing.

With efficiency and simplification previously receiving relatively little of management's attention, banks' efforts to reduce complexity have often been stalled in mid-phase. There has been some arbitrage of labor and operating costs through off-shoring initiatives, but little realization of benefits from promising areas such as shared services or process effectiveness. Current headcount levels are unsustainable at projected revenues, and banks have engaged in multiple rounds of layoffs, damaging to internal morale and external reputation. Organizations should, instead identify a structure that is appropriate and scalable to the new realities, and then determine an orderly process to create such a structure.

Perhaps most damaging of all, the prevalence of complex, non-integrated systems and the lack of enterprise-wide insight have made it difficult for banks to be flexible and responsive in an environment where pace is ever increasing. Banks' ability to provide an accurate assessment of intraday risk—and of daily capital levels—remains in question. These layers of complexity and resulting inefficiencies make it much harder for banks, not only to respond to threats, but to identify new opportunities for growth.

With many banks' cost bases so high and their costs so "sticky", their costs recede much more slowly than revenues despite management's austerity drives and structural changes. This is due fundamentally to two issues: First, the challenge of reducing complexity, to resize for leaner times and new strategies; and, second, the continuing need to invest, for example, in new business models or in the large and continuing demand for regulatory compliance. Our analysis of capital markets firms identified distinct categories of high performers, including "scale winners" and "focused winners." There are multiple routes to high performance and success is not dependent on scale.² Banks seeking to adapt new business strategies—to become niche regional players, for example, or volume-based "flow monsters"—will require very different operational approaches, but all banks must tackle the issue of complexity in order to prosper.

3. Effectively implementing far-reaching and complex new regulations

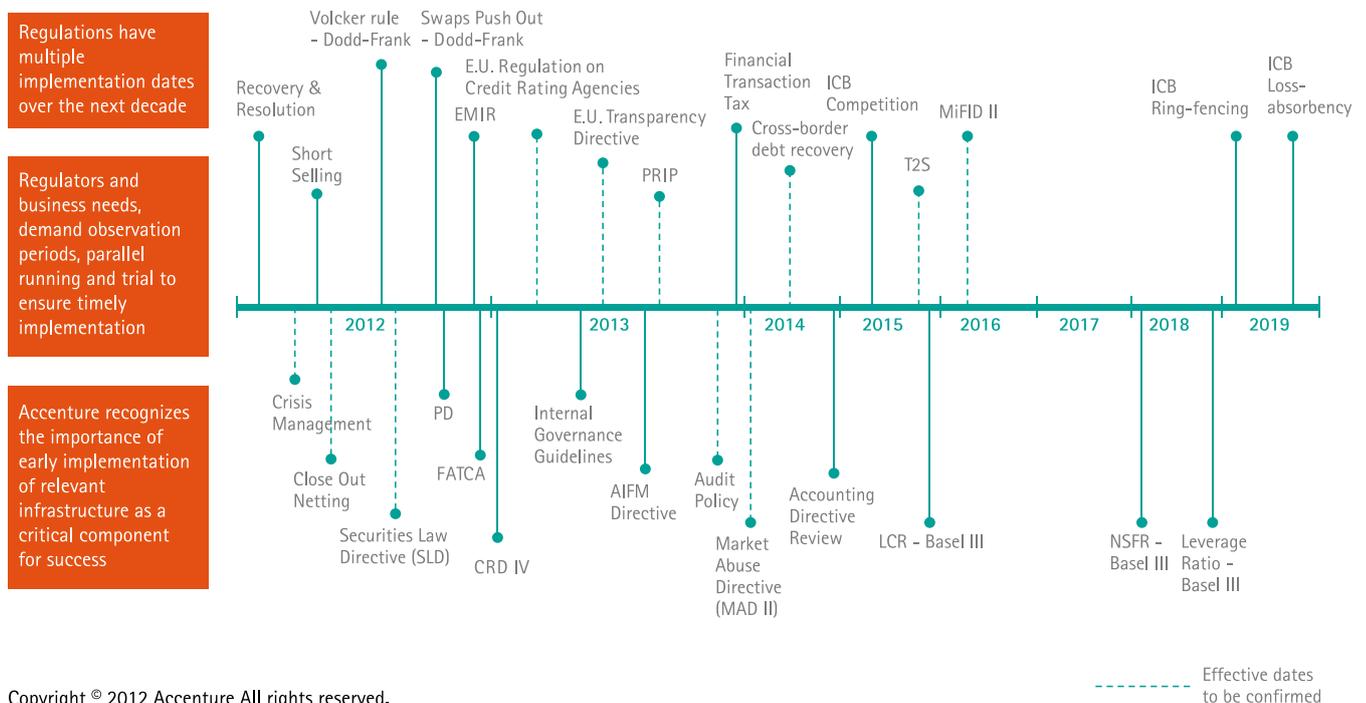
Broad-ranging regulatory reform will affect every aspect of banks' business models, operations and infrastructure. Regulations are becoming more complex and require more management attention—and much more money and resources—for an appropriate response. It is becoming increasingly clear, in fact, that dealing with regulation is becoming a core part of the banking business, a make-or-break capability and not just a peripheral concern. As seen in Figure 1, the regulatory landscape is crowded and there are numerous initiatives scheduled for both short and medium-term implementation. There are many other initiatives outside the scope of Figure 1, and the landscape continues to change rapidly.

These regulations have multiple implementation dates over the next decade. The near horizon includes recovery and resolution plans or so-called "Living Wills"; short selling regulations; and the Volcker rule under the Dodd-Frank Act, which limits banks' proprietary trading activities. Other regulatory initiatives such as Basel III are more far-reaching in their coverage; however, have relatively long implementation timelines. Financial institutions should take immediate action but also need to plan holistically to align regulatory change with the firm's own strategic direction. Unfortunately, there is a tendency to focus on the immediate 12 to 18 month outlook—or even shorter term—which can lead to isolated tactical solutions resulting in inefficiencies and wasted investment over the medium and long term.

Many of the important elements of major new regulations are still to be determined. For example, more than 300 of the 400 rules mandated by Dodd-Frank have yet to be filled in, forcing firms to comply with a law that *The Economist* termed "partly unintelligible and partly unknowable."³ Similarly, there are problems caused by unintended consequences. Requirements increasing capital can result in restricted lending, or restrictions on proprietary trading may result in lower liquidity in key bond markets, neither of which is desirable.

Figure 1
Regulatory Timeline

There is an avalanche of regulatory reforms on the horizon



Copyright © 2012 Accenture All rights reserved.



Seeking Commonality

While there is a tremendous increase in regulatory activity, there is no specific framework for companies to follow in developing their regulatory response. Instead, companies must create their own framework to bring order and structure to the process.

There are multiple global regulations seeking to achieve similar objectives but working on different timelines. Most organizations focus primarily on the differences across the regulatory landscape. We believe that one of the keys to an organized, effective response to regulation is commonality; that is, to identify the regulatory elements common to various requirements—across relevant geographies—and address them through an integrated approach to avoid reworking and confusion. Banks in this situation are like cities faced with replacing underground gas, electric and water lines. It is better to have a comprehensive plan—and to get all the work done at the same time—than to tear up the same roads repeatedly.

There are many areas of overlap. For example, Markets in Financial Instruments Directive (MiFID) II in the E.U. will focus on comprehensive reform of the over-the-counter (OTC) derivative market, while European Markets Infrastructure Regulation (EMIR) seeks to establish standardization of clearing and transparency of OTC derivatives in the 2012-2014 time period.

Dodd-Frank seeks to reform the OTC derivative market in the United States and has similar objectives and overlaps with both MiFID II and EMIR. While a firm date for implementation of MiFID II has not been established, financial institutions with operations in both the E.U. and the U.S. will benefit from adopting a common approach that harmonizes OTC derivative activities wherever they take place.

Regulations can be extraordinarily complex (Dodd-Frank runs over 2300 pages in its entirety) and for institutions to deal with such regulations effectively they need to be “componentized” or broken down into individual tasks. While it is most efficient to co-ordinate and execute functional programs, many financial

institutions find it useful to have a “guardian” of each major regulation. This helps ensure compliance and support proper interpretation of new and existing rules. Ownership can then be assigned to specific areas including capital and liquidity impact; clearing processes; collateral; trading venues; transaction reporting; risk models; and issues specific to different regions. In each case, a clear relationship between the proposed regulations and the business and functions they affect should be visibly established.

Regulatory Change: Setting Strategic Priorities

According to Accenture research⁴, more than 90 percent of banks expect “significant or somewhat significant” change in regulatory risk over the next two years. As a result, many are putting large-scale change programs in place to ensure an effective response. However, as discussed in this paper, regulatory requirement will, by definition, make some parts of the business more costly and/or less profitable over time. The key to successful change programs is to determine in which parts of the business the bank wants to remain (with the regulatory impact incorporated) and steer toward that future. It is highly unlikely banks will be able to keep the same business model and simply plan on absorbing the impact of the new regulations. Banks should also institutionalize capital performance measures within their business strategy if they are to support the overall success of such response programs.

The cost of compliance is high and increasing rapidly, but those organizations that institute a centralized, strategic regulatory response program have more control over managing and optimizing their investment in compliance. While banks recognize the importance of such programs—with 92 percent of banks saying they have a clear sponsor for their regulatory response program, and 67 percent saying that such programs are sponsored by “C” level officer such as the Chief Executive Officer, Chief Risk Officer, Chief Financial Officer, Chief Operating Officer or Chief Compliance Officer⁵—most organizations have not previously demonstrated the

rigor and commitment to ensure the change program stays on course and delivers more than basic compliance.

Assessing Regulatory Impact

The introduction of so many new regulations means that banks will have to set priorities in order to be effective in terms of their responses. There are simply not enough resources/time/money/people to address every tactical aspect of every regulation.

A coordinated response to regulation also requires an assessment of the impact of regulations on each area of the business. For example, the Basel III /Capital Requirements Directive (CRD) IV provisions addressing capital requirements have a high potential impact on derivative transactions in particular where higher levels of capital will need to be held to deal with the creditworthiness of the counterparties also known as the CVA charge. However, syndicated lending will experience relatively low impact since minimal funding is required, which can potentially be incorporated within the pricing.

In many cases, financial institutions have a range of options regarding the implementation of responses to these new regulations. These options range from basic compliance to a comprehensive, optimized outcome which uses the regulatory response as a lever to make needed changes in the business model. Banks should understand this concept and make deliberate decisions about the trade-off between compliance costs and the costs to achieve an optimized state—across the spectrum of required regulatory changes, and with the support of the business leads for priority strategic system and process enhancements. These choices will not be easy, but banks must establish priorities and determine what resources and funding will be needed to reach these objectives through the appropriate path.

The Execution Challenge

The framework for regulatory response needs to be closely tied to the bank's overall strategy.

Ideally, the regulatory response becomes an integral component of the strategy, rather than a standalone initiative.

As mentioned, we believe that the best approach to complex regulatory demands is to organize them into common themes for implementation, with multiple regulations broken down into specific components so that the common aspects of multiple requirements can be dealt with in a single solution. To assist in this process, Accenture maintains a

comprehensive regulatory database to help the bank review and structure the change initiatives it must address against the required timelines and desired outcomes.

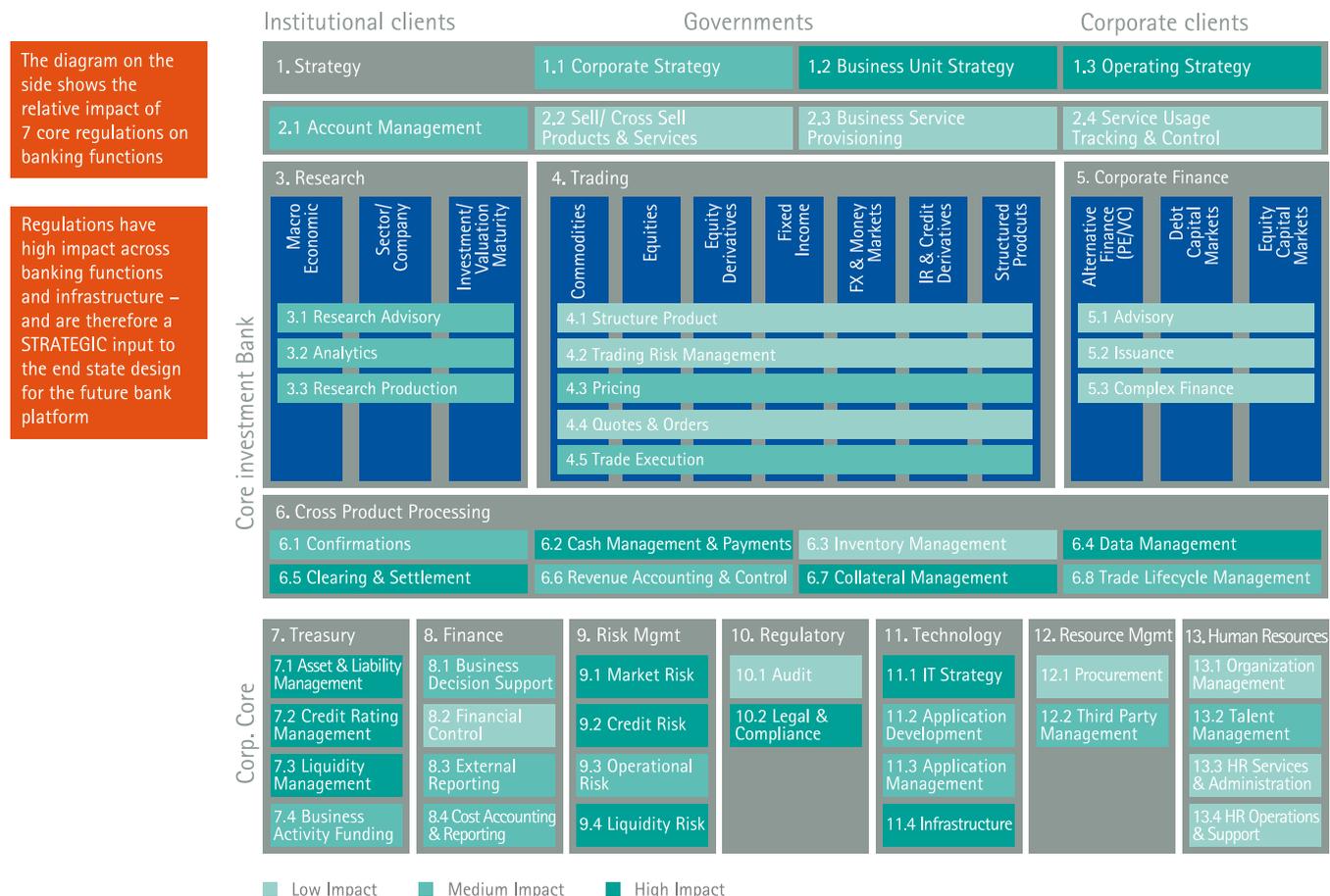
The bank should assess the impacts of each regulation (implementation cost, product profitability, data model, business process, etc.) and the regulations as a whole against the desired strategy; and chart a course to the business model that will enable that strategy—and can be supported by an

infrastructure which is robust enough for the requirements but also efficient enough to be affordable with the needed size, scope and flexibility.

In order to ensure that the organization retains the broader perspective, it is important to take a business model view of the impacts of the change program, highlighting the involvement of all areas—not just Risk Management and IT—as shown in simplified form in Figure 2 below.

Figure 2
Execution challenges

A clear relationship to the business and functions needs to be established



Copyright © 2012 Accenture All rights reserved.

With this view the financial institution can develop regulatory implementation programs based on the business priorities—getting the most return from their required regulatory investment. For example, in strategic areas related to the business model and to establishing and maintaining a competitive advantage, programs may be designed and implemented to separate retail from wholesale activities; to limit risks from proprietary trading; or to change the business model. Another common functional component is technology, and here implementation programs may be aimed at integrating finance and risk architecture; improving data governance and the overall quality of data; or at sourcing and distributing reference data. Market initiatives might include linking with central counterparties for derivatives or developing solutions that more closely correlate collateral requirements with securities held and/or traded.

This is not to underestimate the implementation challenges posed by regulatory changes themselves. At a minimum, financial services firms will need to set up effective governance for their regulatory programs; transform and align finance and risk functions; revamp current client on-boarding and data collection processes; establish stronger frameworks for operational risk; and develop crisis management plans. In addition, regulations impose stronger efforts aimed at curbing financial crime, including anti-money laundering measures and development of client solutions for compliance with the Foreign Account Tax Compliance Act (FATCA). These encompass extended reporting structures, new Know Your Customer (KYC) processes and will require a significant level of investment and resources for both U.S. and non U.S. banks.

Even organizations that choose only to meet basic compliance standards will have their work cut out for them. The desire is to create an approach which also returns tangible benefit to the organization beyond the basics of meeting these regulatory hurdles.

Once priorities have been identified, key common themes should be aligned with the right leaders (business and functional) and teams within the organization. Major implementation challenges have overlapping demands that call for cross-functional coordination. For example, Dodd-Frank, Basel III, MiFID II, EMIR and CRD IV all have certain requirements or elements that will result in changes to the affected institutions. Doing so will necessitate coordination among the finance, risk, treasury, operations and technology functions, as well as the business lines themselves. Governance of mandated regulatory response implementation will demand a similar level of coordination across key functions.



Assets and Tools for Regulatory Compliance

Accenture has created an extensive range of assets and tools to help organizations implement compliance programs and create value from optimized implementation. These fall into four main categories:

1. Change Identification. We have developed a series of tools that help banks track the regulatory rules, to determine the impact of specific clauses and articles on businesses and functions, to determine business and technology requirements and to determine options.

2. Change Management (Program Design and Roadmap). We have created target timelines, program structure, architecture, and change management approaches that can be customized by financial institutions. These tools help ensure a holistic treatment of complex change management programs and also support prioritization and delivery.

3. Change Delivery (Targeted Solutions). We are developing solution architectures to support compliance capabilities for major changes including:

- Changes in business model
- Ring-fencing wholesale from retail
- Restrictions in proprietary trading
- Deleveraging without destruction
- Central counterparties for derivatives
- Client and market connectivity
- Developing collateral solutions
- Optimizing capital and RWA
- Optimizing liquidity
- Governance implementation of regulatory program
- Transforming finance and risk
- Client on-boarding and data
- Operational risk framework

- Effective crisis management
- Financial crime, including anti-money laundering
- Developing FATCA client solutions
- Integrating finance and risk architecture
- Data governance and quality framework
- Sourcing and distributing reference data
- Orderly liquidation planning

4. Sustaining Compliance. We have developed architectures to support firms creating their own capabilities to sustain compliance and manage regulatory communication and risk management.

While these assets and tools are effective as individual actions, they are much more effective as part of a comprehensive approach to the regulatory challenge. We work with clients to use these tools and assets as part of an integrated framework for addressing regulatory change and aligning firms' strategies with new regulatory realities.

Conclusion

The scope and nature of global regulatory change will transform the financial services industry.

We believe that financial institutions must come to grips with the concept that regulation is no longer a secondary concern but is now a primary consideration in determining strategic direction. By developing better ways to manage risk and address higher requirements for capital and liquidity, firms will find new ways to be profitable within a demanding regulatory environment.

We believe that high-performing banks will view regulatory change as an opportunity for competitive differentiation. They will seek, not just to be compliant with new rules and regulations, but to benefit from the investment in regulatory response and develop a business model that leads to profitable growth in a new environment. The "old days" may be gone but we believe that such organizations can take a significant step forward into the new era.

Notes

1. **The Point: Banking 2012** (<http://www.accenture.com/us-en/Pages/insight-the-point-banking-2012-summary.aspx>)
2. **High Performance Investment Banking—Accenture Point of View** published January 2012 (www.accenture.com/HPIB)
3. **Over-regulated America, The home of laissez-faire is being suffocated by excessive and badly written regulation.** *The Economist*, February 18, 2012. Accessed on February 20, 2012: <http://www.economist.com/node/21547789>
4. **2011 Global Risk Management Research** (www.accenture.com/globalriskmanagementresearch2011)
5. **2011 Accenture Regulatory Response Benchmarking Survey**

About the authors

Steve Culp

Steve is the managing director – Accenture Risk Management. Based in London, Steve has more than 20 years of global experience in strategy definition, risk management, enterprise performance management and delivering large scale finance operations engagements. Prior to his current role, Steve was the global lead for Accenture's Finance & Performance Management consulting services for global banking, insurance and capital markets institutions. With his extensive risk management and performance management experience and business acumen, Steve guides executives and their teams on the journey to becoming high-performance businesses.

Adam Markson

Adam is executive director – Risk Management. Based in London, he specializes in investment banking, capital markets, data and operating models and finance, risk and middle office technology. Adam brings over twenty years of consultancy and industry experience to planning, managing and implementing major change programs for global financial services firms determined to become high-performance businesses.

We would like to thank Kumar Ved for his contributions to this publication.

About Accenture Risk Management

Accenture Risk Management consulting services works with clients to create and implement integrated risk management capabilities designed to gain higher economic returns, improve shareholder value and increase stakeholder confidence. For more information about Accenture Risk Management please visit www.accenture.com/riskmanagement

About Accenture

Accenture is a global management consulting, technology services and outsourcing company, with 257,000 people serving clients in more than 120 countries. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world's most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. The company generated net revenues of US\$27.9 billion for the fiscal year ended Aug. 31, 2012. Its home page is www.accenture.com.