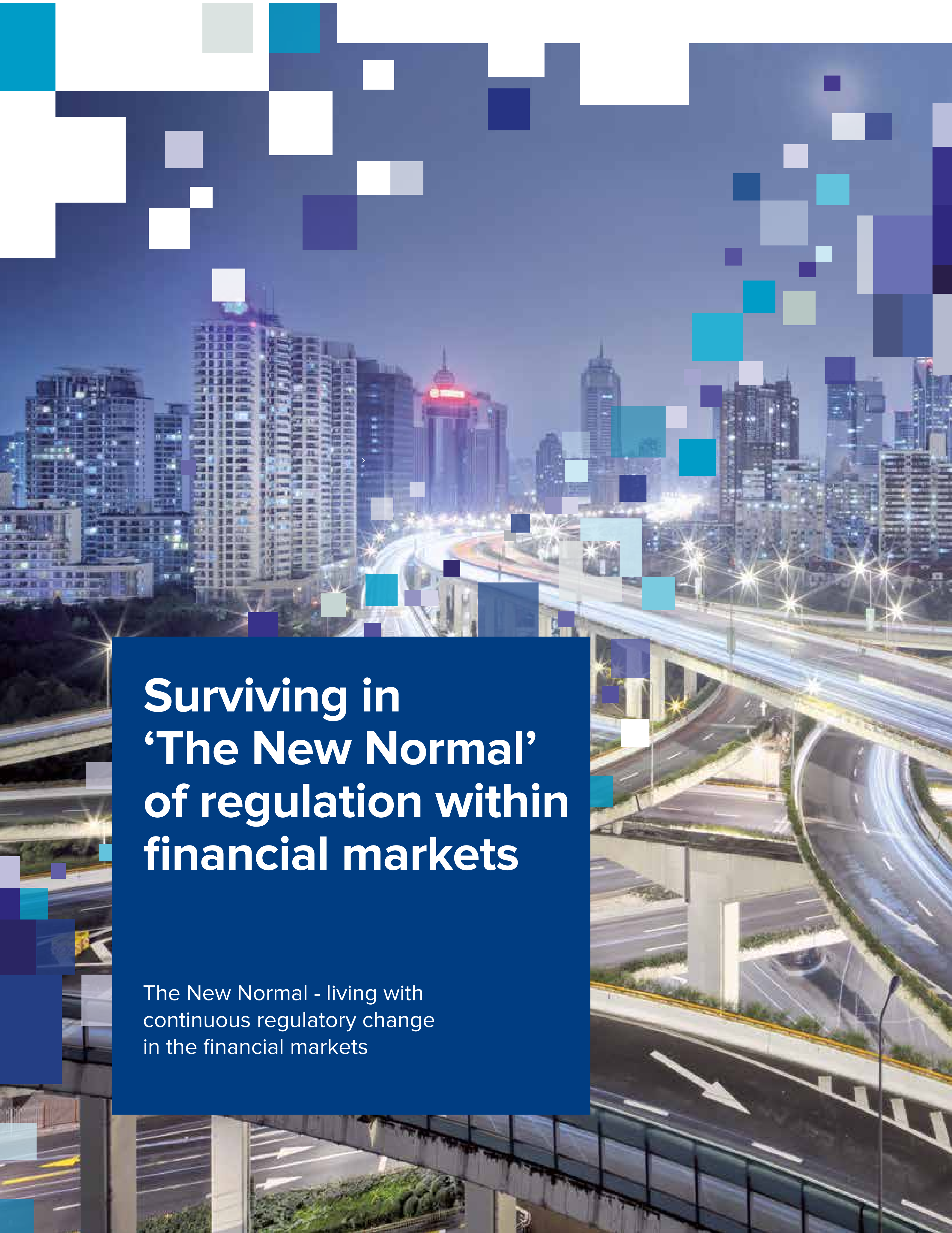

Surviving in ‘The New Normal’ of regulation within financial markets

The New Normal - living with continuous regulatory change in the financial markets

Introduction

Since the financial crisis of 2008, a huge amount of work has been undertaken by regulators and market participants in addressing many of the serious issues that directly caused the crisis.

In 2015, we find ourselves at an inflection point, where we are moving away from pure regulatory compliance, to assessing the impact of regulation on business models, operating models, client interaction, reporting, and the actual products which firms want to trade, all of which should ultimately result in an improvement in return on equity for investors.

Against the backdrop of this dynamic landscape, GFT decided to ask key questions about how firms are reacting to the accelerating volume and pace of new regulation, and what strategies they have in place to cope. The in-depth research surveyed 66 firms across global capital markets, including global and domestic investment banks, and CCPs in the UK, Europe, North America, and Asia. The research looked at participants' strategy, their future plans, levels of compliance, management of risk and data, as well as specific 'deep-dive' items on related regulatory topics.

The New Normal - executive summary

The overwhelming majority of respondents (95%) believe their firms now operate in 'The New Normal' of regulation; a world in which regulatory directives will continue to increase. Respondents agreed that the tipping point into this new world was around the beginning of 2013.

The majority of respondents (85%) believe they now have the opportunity to make better business decisions based on the insights gained from data provided as a result of regulatory changes. Most banks are actively measuring the impact of regulation on their businesses, as well as communicating regulatory information inside their firms. However, the level of measurement and method of communicating regulatory change varies between companies.

Regulation continues to be viewed as an exercise in compliance for most firms. Many agree that since the 2008 financial crisis, regulatory change has increased the focus on compliance rather than business innovation. Most respondents (86%) admit that their firms pursue tactical work-arounds to meet regulatory requirements, indicating that they are approaching regulation from a tactical rather than a strategic standpoint. What is of more concern is that only (18%) of respondents view regulation as an opportunity to drive strategic investment and business change.

The picture that emerges is one where financial institutions accept that they now operate in a new regulatory environment, where there are new business opportunities. However, they are failing to adequately tackle the challenges of regulation or take advantage of the strategic opportunities for change that it offers.

1) How do banks view regulation?

It is accepted that regulation has become a natural part of the business environment in which financial institutions now operate, but the findings from the survey reveal that the views on regulation from respondents do not always correlate with their actual response in dealing with the required changes.

An overwhelming majority (95%) of respondents agreed with the premise of 'The New Normal', and believe their firms operate in an environment of constant regulatory change. Many believe that the pace, scale and concurrency of this change has increased in recent years.

Due to the nature of ongoing new regulation, it is perhaps unsurprising that there is no definitive date on which we can say 'The New Normal' became a reality. However, based upon the research findings, the transition into a world of constant regulation is perceived by respondents as having occured at the end of 2012 / beginning of 2013. The timings for this perceived tipping point vary, based on where respondents are located (North America, Europe or Asia), and whether they were subject to high-impact regulation.

This regulatory environment has been in existence for a significant period of time, but the consensus remains that regulation is still merely an exercise in compliance. This is especially true in North America, where the strength of enforcement orders against firms places a greater emphasis on ensuring firms are absolutely compliant with regulations to the letter of the law, as opposed to the European model which takes a more principle-based, holistic view of regulation.

Most agree that since the 2008 financial crisis, regulatory change has increased the focus on compliance rather than business innovation. However, it has also been expressed that regulation has created the opportunity for firms to make better business decisions, driven by operational innovation. There appears to be some contradiction in the opinions expressed by respondents in this area.

However, the view that regulation remains an exercise in compliance is re-enforced by the over-reliance on tactical work-arounds. Such work-arounds may achieve short-term compliance goals, but inevitably lead to a legacy of 'technical debt', which will require remediation at a later date. Banks acknowledge and accept this, but surprisingly, 40% of respondents do not believe further remediation will be required.

Respondents in our survey expressed the view that they are thinking about regulation in a strategic way. They are aware of the long-term business benefits from innovating and changing, but unfortunately, their actions do not support this view. Banks need to reduce the amount of tactical work-arounds they are using, and begin embracing the potential for business innovation. We have now reached a point where regulation can no longer be seen as simply a 'box-ticking exercise' in compliance.

2) The impact of regulatory change

The post-2008 financial world has been defined by a decline in profits for certain business units and lower return on equity (ROE) for shareholders. Wide-ranging regulatory requirements have contributed heavily to this. If banks are to successfully navigate and respond to these demands, they must accurately measure the regulatory impact on their business lines and processes. To succeed, they need to monitor the effects of regulation, and use this information to plan and adapt their firm. This process is taking place, but not at the pace and scale needed if banks are to make the rapid improvements required.

However, the vast majority of respondents (85%) believe they have been able to improve their decision-making ability as a result of regulatory change following the financial crisis. The increased focus on regulation has forced firms to reassess their business models, analyse profitability, and focus on their data aggregation capabilities, which in turn have helped them make better business decisions. This is further supported by the 85% of respondents who feel that regulation has encouraged their firm to develop better analytics, which supports their decision-making.

However, when questioned on how they actively assess the impact of regulatory change on their business, the response from firms does not fully support the claim that their decision-making abilities have been improved. Just under half of respondents (48%) said they monitor the impact of regulatory change and use it to plan and adapt their firm, while 36% measure the impacts, but do not adjust strategy as a result of these findings. Perhaps more surprising is that 12% do not measure the potential impact at all!

G-SIBs v D-SIBs

Our survey findings revealed that 65% of global systemically important banks (G-SIBs) use regulatory change to plan and adapt their firms, while only 30% of domestic systemically important banks (D-SIBs) claim to do so. The most likely reason for this, is that due to their size, the G-SIBs already have established processes in place to disseminate regulatory information and make change in a planned way. For the G-SIBs, regulatory change has become 'business as usual' quicker than for the smaller D-SIBs.

Measures used to assess the impacts of regulation

Of those firms that assess the impact of regulatory change, the majority do so across the most important financial indicators-capital, profitability and revenue-with over half (55%) of firms assessing the impact every time there is a new regulatory change. These institutions acknowledge that reviewing financial impacts consistently, across a number of indicators, allows them to gain an advantage over those firms that are failing to do so. This is especially the case when we consider the increasing scale and depth of regulatory change.

One of the defining features of the 'The New Normal' environment is that the impact and effects of regulation are now being felt across multiple business units and departments. Since the 2008 crisis, 58% of respondents claim that regulatory change now impacts two or more business units, while 52% feel it now requires change in two or more business functions.

Impact on business units

The challenge for banks is how they can tackle regulation which impacts the entire business, when so many of their current operating models exist in departmental or divisional siloes. With different business units being affected across the firm, it highlights the importance of adopting strategic rather than tactical approaches to regulation. A strategic approach, for example, would include creating a central regulatory function that coordinates a firm-wide response to new regulation across the entire enterprise or in multiple businesses units.

Reviewing and consolidating - streamlining the business

The increasing volume and concurrency of regulatory change is encouraging banks to consolidate their business functions, making them more efficient and cost-effective. The research shows that 53% of respondents agree that regulation helps them to consolidate their business. Comparing responses regionally, this figure is much greater in the UK, where 86% agree with this view, compared with only 29% of US and Canadian banks.

However, overall, a third (32%) of firms claim that regulation has hindered their ability to drive consolidation, potentially due to the large volume or regulatory changes required and a compliance-led / tactical approach. Taking a regional view, the US and Canadian respondents are more pessimistic, with 53% claiming that regulation has hindered their business, potentially due to the more prescriptive nature of regulatory enforcement.

3) Meeting regulatory change

Communication

In addressing the challenge of continuous regulatory change, banks must ensure that they communicate and educate key internal stakeholders within their business on current and upcoming regulations that will affect the firm. With regulation having an impact across different business lines, the communication of regulatory information within firms takes on added importance. Our report reveals that the communication of regulatory information is now almost universal, but how it is communicated varies significantly.

A single uniform source is the most effective way to communicate regulatory information, but it is clear that achieving this remains a distant goal for many firms, with only 20% communicating in this manner. Multiple uniform sources of information are used by over half of respondents (52%), with G-SIBs reporting a higher instance of this (61%) compared to D-SIBs (48%). Non-uniform multiple sources (i.e. scattered, inconsistent information channels) are used by 28% of respondents overall. These figures demonstrate that many firms are not communicating regulatory information as effectively as they could, with the result being further confusion surrounding the information and actions required.

Communicating regulatory change effectively also requires banks to have clear visibility of the full portfolio of regulatory change. Almost all respondents (95%) claim their firm is able to see the full portfolio of regulatory change across the enterprise, but only 30% have this portfolio view all of the time. Greater visibility of regulatory change allows institutions to be more efficient; it is important that banks can understand the impacts of regulation across the business rather than focusing on the individual aspects of compliance, which may have downstream impacts in other areas of the firm. Regulation will impact different business units in different ways and it is important that firms can see the entire picture of how each regulation will affect the firm overall.

Our survey results suggest communication strategies remain disjointed, with firms at different levels of maturity in how they communicate regulatory information. Banks need to develop strategies that will allow them to develop their communication processes further around regulatory change, making it as efficient and simple as possible for employees to gain information from a single unified source.

Tactical versus strategic

With the pressure of meeting regulatory compliance increasing, it is both unsurprising and concerning that 86% of respondents continue to pursue tactical work-arounds to achieve regulatory compliance. The majority (58%) take this approach because they are concerned about their ability to meet regulatory time-frames. There is also the added difficulty in making changes to large, embedded legacy systems, which inevitably leads to tactical, point solutions rather than a strategic approach.

Respondents readily admit and accept this over-reliance on tactical work-arounds, while also understanding that tactical work-arounds accrue future 'technical debt'. Our results show that 42% acknowledge that this debt will require future remediation; however, a surprising 40% agree this debt is accrued, but that it will not require future remediation. This figure rises even higher for North America, with 67% taking the view that future technical debt is acceptable. However, the reality is that at a future date, most firms will need to revisit these work-arounds as they begin to increase operational running costs and make scaling the business even more challenging. It is clear that data flows and reporting systems currently in place are not streamlined enough to cope with constant regulatory change, and manual work-arounds are used as a quick fix solution in many cases.

The technical debt being accrued will continue to increase over time, but our report provides little evidence that firms are putting in place strategies to overcome this mounting problem.

Conclusions

Banks have generally demonstrated a positive attitude towards regulation, acknowledging that there are a number of opportunities created as a result of new regulatory requirements, but succeeding in this environment will not be easy. Since the 2008 crisis, banks have been operating in an increasingly tough environment of decreasing profits, huge regulatory fines and challenging ongoing regulation.

Banks must urgently ask the critical questions on how they can operate and perform better in the new regulatory paradigm, where returns on equity and capital are significantly lower than before the 2008 financial crisis. They cannot simply go back to how they used to operate after solving the latest regulatory challenge, since it is now clear that regulation is not a temporary phenomenon; it is here to stay, and firms must adapt to this or face the consequences.

Our five steps to cope with The New Normal'

¬ Review business models

Regulation needs to be considered in its wider context, with banks identifying how each regulation will impact business units across the firm as a whole, rather than looking at each regulation in an individual silo. Banks will also need to seriously consider which of their business lines can remain competitive and profitable in the new paradigm.

¬ Resist implementing tactical fixes

In addition, the continuing over-reliance on tactical fixes will only increase costs further, leading to a rise in technical debt. Tactical fixes and increasing technical debt are not sustainable; banks need to start reviewing their business models and client relationships and invest in more efficient enterprise-wide technologies in order to be flexible and ensure that they can thrive in this new world of continuous regulatory change.

¬ Take a holistic view of regulation

The sheer volume of regulation is set to rise dramatically. Currently, there are over 60,000 pages of regulation that impact banks, and this is estimated to rise to 120,000 pages by 2020. The complexity of bank business models, the prevalence of legacy IT systems and the overlapping impact of global regulation makes this a very difficult task to manage. Often, an individual regulation that affects one part of the enterprise, business unit, or trade lifecycle can have a positive impact locally, but a negative on another part of the business.

It is important to understand the positive and the negative impacts of regulation across the firm. Regulation needs to be viewed as an 'embedded process', rather than just being the responsibility of a few people in compliance or IT. There is now a much greater understanding that on boarding new regulation, assessing the impact of regulation, understanding the regulation, codifying the regulation, and reviewing the impact on individual business lines is something that has intensified since the financial crisis. Senior management needs to take a step back and review the overall impact across the entire enterprise.

¬ Focus on data quality

The New Normal of continuous regulatory change requires banks to answer important questions from regulators about how well they are governed and managed. Access to the correct management and financial data is crucial to enabling this to happen. Being able to aggregate high quality risk and financial data is an essential component in the new regulatory environment. Having a 'golden source' of data - stored in one place, with a single view - will help reduce operational and IT costs and improve future efficiency.

Most regulation is about measuring data and about demonstrating that the firm is 'safe'. Firms that cannot demonstrate to regulators they are 'safe' will be required to hold more capital reserves and liquidity buffers. If business data is distributed and stored across the enterprise, or the lineage of that data is unclear, it will be impossible to aggregate automatically, or confirm that it is sound.

¬ Improve or replace outdated technology

The difficulty for banks to achieve easily aggregated data is caused by their plethora of disparate data sources, systems, and unintegrated processes within the firm. The existence of these poor data structures and legacy data models are just some of the factors that contribute to the use of tactical work-arounds. Making improvements will require a review of data governance structures as well as assessing how new and existing legacy technologies can be leveraged to aggregate data better, to make improved business decisions, and answer regulatory questions.

The message from our survey results is very clear. Banks that are likely to be successful in future will be those that are able to treat regulation as an opportunity to take a strategic approach that will transform their business.

Banks claim that they recognise the benefits of regulation but some are failing to act strategically or quickly enough to realise the benefits. The challenge that lies ahead is in making bold decisions that will fundamentally change the nature of the bank and unlock the opportunities on offer.

The successful investment bank of the future is likely to look very different from those that exist today. Each institution must strive to review what all of the regulation means for every part of their business and adapt their business models accordingly to survive and flourish in The New Normal.

Featured Specialists

Alan Morley

AML & Risk Practice Lead (USA)

As AML and Risk Practice Lead, Alan focuses on how best to change compliance, AML and risk operations through new processes and targeted IT investment. He and his teams are currently guiding new and automated AML risk assessment services and are helping in the early identification of rogue traders for major international banks.

With GFT, Alan has been involved in addressing immediate regulatory and compliance challenges focusing on risk assessment, business process, policy and workflow. He has co-designed and developed new global compliance risk assessment frameworks, methodologies and executive reporting systems, supporting more accurate targeting of transaction monitoring systems and the identification of rogue trading and potential market abuse.

John Barclay

Managing Principal, Risk Consulting

John is a Managing Principal in risk consulting, with over 20 years' experience in risk and front office areas in investment banks, delivering strategic solutions for credit and market risk management and Front Office derivatives modelling and trading. John has worked in technology, quantitative and business roles to define strategies and deliver systems across numerous areas including equity derivatives, synthetic finance, energy derivatives and rates, and has migrated whole businesses onto new P&L, risk and pricing platforms. John previously worked at Goldman Sachs on as well as undertaking similar roles with JP Morgan, Credit Suisse and Barclays.

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