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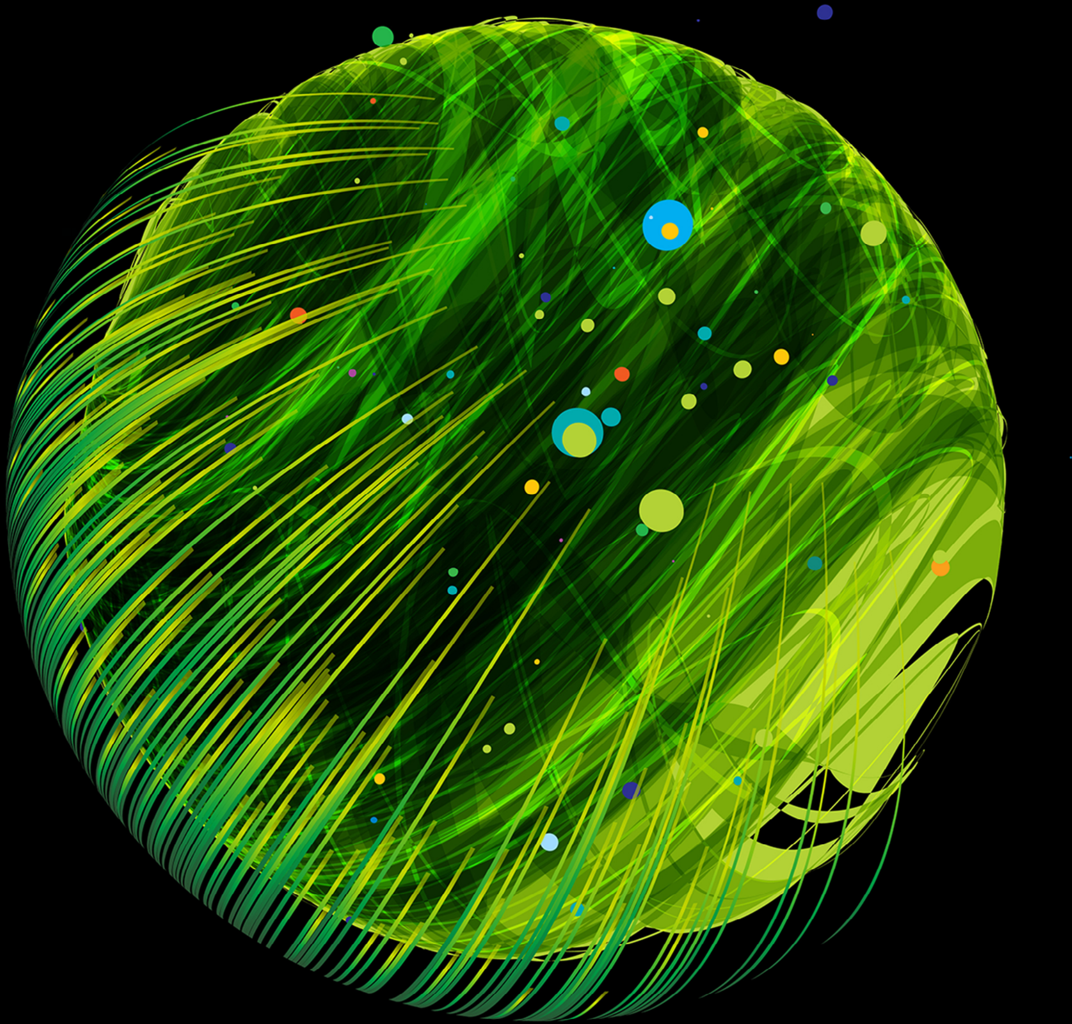


Business and Entity Transformation: Reducing risk and regulatory blind spots while driving business strategy

Financial institutions look for ways to optimize costs and product mix

The past decade has represented a complex period for the financial services industry, both domestically and abroad. Two of the most significant economic events in history, the global financial crisis and the COVID-19 pandemic, as well as resulting business pressures, have dramatically reshaped the financial services landscape and reframed market conditions. Disruptive forces, such as digitalization, technological innovation, and rapidly evolving regulatory expectations, have fundamentally shifted the paradigm under which financial institutions operate and have forced organizations to adapt their business models and strategies or risk not being able to compete.

While presenting significant challenges for those unable to adapt, this period has also brought with it opportunities for executives to redefine their organizations' business models and to reposition themselves within the broader financial services landscape for the decade ahead. The ability of executives to take a centralized, end to end view across businesses and functions, legal entities, and jurisdictions, as part of their strategy setting has been critical to achieving success and enabling agility and innovation. This leadership group will also need to keep pace of the economic, industry, and regulatory landscapes for areas of emerging risk.

As the financial services industry transitions from a growth phase into one more uncertain in nature, leaders who consolidate objectives into a singular, coherent strategy should be better positioned to succeed.

But where can you start? And what options do you have?

Getting started:

Upgrade planning from siloed to integrated

With so many competing interests, approaching business model strategy in a traditional or siloed fashion makes it far less likely that an organization will meet its competitive, regulatory, and stakeholder demands in a timely and effective manner. Instead, leaders should consider developing a new or adjusted management model, using three guiding principles to enable effective decision-making and speed to market.

Ensure a 360-degree view

Organizations should gather data sets across capital, liquidity, risk, tax, regulatory, and other core financials, as well as peer and market information, to enable scenario planning. These data sources should be able to be leveraged for future decision-making.

Define a sustainable process

Organizations should ensure that key strategic decisions are applied and executed in a way that breaks down silos and enables organizational and managerial agility (for example, as new regulatory and market changes occur, the organization should be able to quickly pivot and make decisions). Financial institutions should define decision-making processes, balanced scorecards, and guiding principles for business model strategy efforts that can be sustained.

Form a central leadership group

A cross-functional group of senior-level executives and subject-matter specialists should take a top-down view of your business model strategy and weigh decisions across multiple dimensions, enabling organizational agility and the integration of business, market, customer, and regulatory considerations into business model decisions. This group should be supported by a quantitative and analytics-oriented team with defined roles and responsibilities that can support consumption of a large amount of data sets.

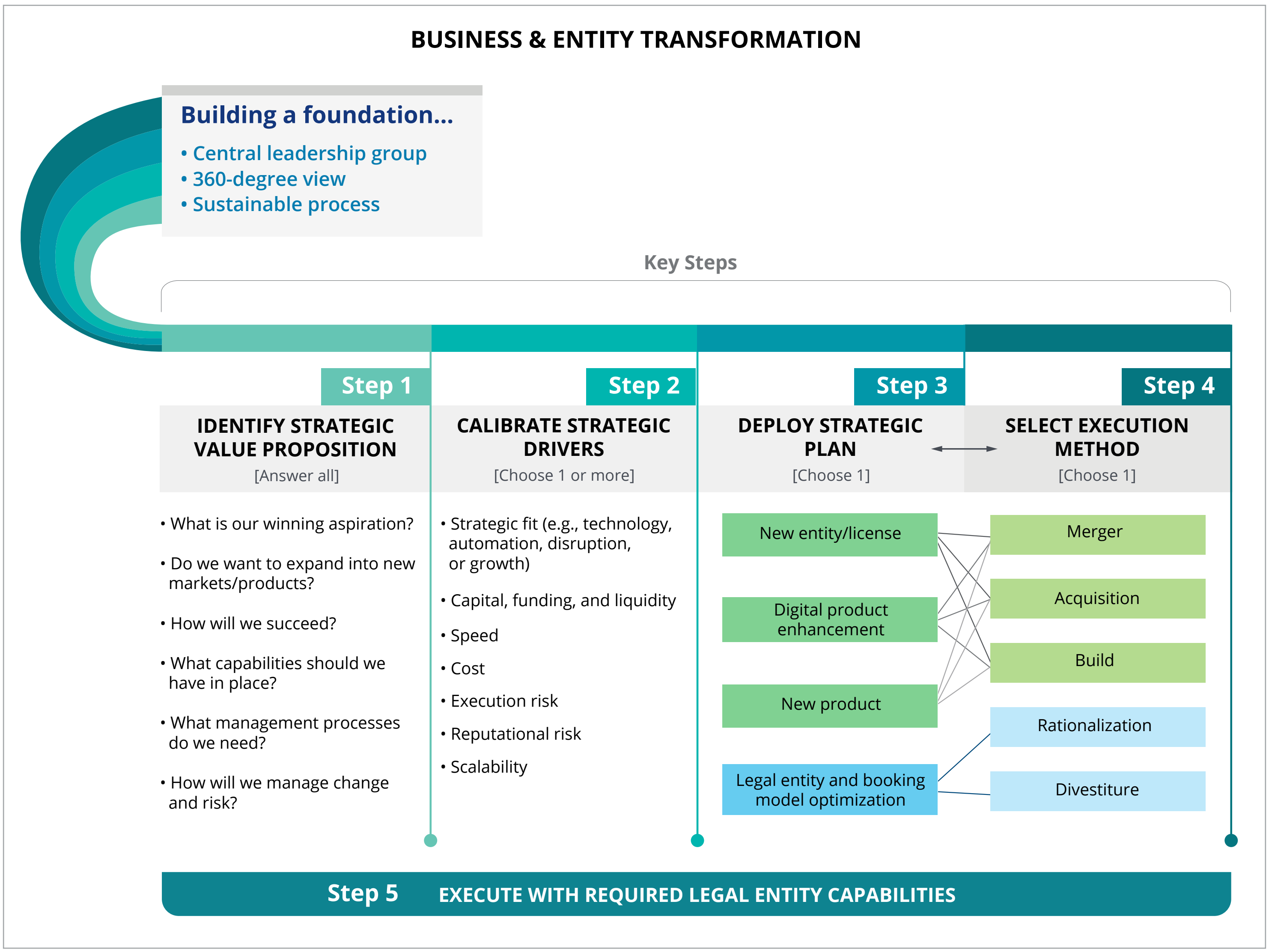
Case study: Large global bank develops comprehensive legal entity strategy

In response to industry competition and increased cost pressure, a banking organization was looking to optimize its business model strategy to achieve better product alignment and capitalize on cost optimization opportunities through legal entity rationalization. The organization created a central leadership group representing all functions.
The organization developed a hypothesis and blueprint of the future product, legal entity, and business strategy for the firm's US businesses. Management had a perspective that the global regulators would force more subsidiarization of businesses booked within a nation's borders.
This was informed by emerging marketing trends. As regulatory developments shifted, they maintained that blueprint and were able to shift focus and take advantage of digital banking deposit opportunities, as well as other optimization opportunities. They made strategic legal entity choices, including merging two broker-dealers into one, and redesigned their digital banking proposition, refocusing their business model on the core elements that were differentiated. This critical strategic pivot was facilitated by the presence of the central leadership group, without which the organization would not have been able to act in a nimble and opportunistic manner.

Turning disruption into opportunity:

Alignment of business strategy and regulatory strategy

Disruption and economic change can bring opportunity, and today's changing landscape presents executives with a chance to reflect upon their strategic objectives and consider new growth and resiliency blueprints. With the current environment serving as a driver for strategic change and so many strategic choices available, the question has become less about whether to adapt and more about how.



Step 1:

Identify strategic value proposition

When considering its business strategy, the central leadership group should take a structured approach toward decision-making, as well as the development and execution of organizational strategy. This should include determining its strategic aspiration, where it will "play," how it will "win," what capabilities it has in place, and how it will be able to manage execution of its strategic vision. What follows are some of the questions the central leadership group will need to answer when seeking to identify its strategic value proposition.

- What does your organization exist to do, and are you positioned to win (both now and in the future)?
- Which customers segments, markets, products, and geographies should you consider and prioritize?
- Are your product mix and distribution channels appropriate for your customers and market?
- Do opportunities currently exist to better serve customers and/or address market demands?
- Does your defined strategy and risk appetite clearly articulate goals and constraints across markets, customer segments, and products?
- Do you have the legal entities and licenses needed to execute your business strategy?
- Do you understand the regulatory landscape in each jurisdiction in which you operate?
- Are additional capabilities or costs needed to execute your business strategy changes?
- Do opportunities exist to improve returns, book assets to a better location, and/or wind down entities?
- Do you understand your current regulatory positioning and posture, and the impact of these on your business and regulatory strategy?

These considerations, informed by existing company risk, financial and client data, and market and peer information, can help define existing options. As part of this step, the central leadership group should also conduct horizon scanning, taking a long-term view of the industry landscape and placing its "bets" on the future appropriately.

Step 2:

Calibrate strategic drivers

When considering business model options, the central leadership group will need to evaluate, tailor, and prioritize objectives based on the organization's own unique business model. The below drivers should be considered across all options and calibrated based on your organization's business strategy.

Strategic fit

Various options may offer advantages relative to your organization's business model and might have further impacts on strategic alignment.

Capital, funding, and liquidity

Source of funding and liquidity may increase your organization's ability to compete over the long term by decreasing volatility across credit cycles. Your organization's funding options and plan will drive the feasibility of your options.

Speed

Your organization's capacity for execution speed, particularly in relation to other strategic drivers, can help determine your optimization path.

Cost

Your organization's ability to assess the opportunity cost of focusing on new structures (such as infrastructure development or regulatory compliance) against other strategic objectives.

Execution risk

Anticipating and addressing key risks (for example, inability to meet regulatory requirements) may result in failure or delay, ultimately postponing business execution.

Reputational risk

Reputation is a valuable intangible asset, and your organization should consider both public and regulatory perception of choosing one objective over another while assessing and prioritizing strategic objectives.

Scalability

Provides the flexibility and optionality to expand, as well as restrict, based on market and industry sentiment and potential changes in the markets.

Taking into account these considerations, your leadership group should be able to develop a balanced scorecard weighing the pros and cons and conduct a feasibility evaluation tailored to its business model and strategic vision.

Critical thresholds to navigate in the United States require optimization focus

With the introduction of enhanced prudential standards (EPS) and resolution planning tailoring rules by the Federal Reserve, the number and complexity of thresholds that drive requirements and expectations for bank supervision and regulation continues to grow. Going forward, as firms grow (organically or through acquisition), change their funding strategies, diversify their operations through acquisitions, or diversify their product offerings, they may find that they have crossed an important threshold. In addition, banking institutions should anticipate and prepare for a change in their thresholds, as a result of pending Basel III and Total Loss-Absorbing Capacity (TLAC) changes. The US regulatory landscape has approximately 15 thresholds across nine key indicators that can have a range of consequences across capital, liquidity, and risk governance domains.

Scenario: Bank Holding Company (BHC) has total assets of $200 billion and needs to comply with capital and bank prudential regulations (as shown in the visual below) based on the inputs in the key threshold indicator section. However, BHC plans to acquire a $60 billion institution, which may result in BHC's total consolidated assets of $260 billion post-acquisition.

Outcome: EPS tailoring requirement changed from category IV to category III, in addition to the other incremental regulatory requirements, which will result in increased scrutiny and supervisory expectations, as demonstrated below.

Regulatory requirements for a US Bank Holding Company

Total assets	Nonbanking assets	wSTWF	US GISBs qualify	LISCC qualify
$260B	$50B	$10B	No	No

List of key indicators	Cross-jurisdictional activity	Off-balance-sheet exposure	On-balance-sheet foreign exposure
	$10B	$25B	$0

Illustrative list of regulations and supervisory guidance

Before expansion

Tailoring requirements* All tailoring rules	Other requirements Capital and risk
EPS — Category I	Risk-based capital surcharge
EPS — Category II	SR Letter 15-18
EPS — Category III	**SR 12-7**
EPS — Category IV	SR Letter 16-3

Resolution planning	Governance
File resolution plans every 2 years	SR 16-11
File resolution plans every 3 years	**SR Letter 08-8**
Does not apply	**SR 12-17**
	OCC heightened standards (only applicable to national banks)

After expansion

Tailoring requirements All tailoring rules	Other requirements Capital and risk
EPS — Category I	Risk-based capital surcharge
EPS — Category II	SR Letter 15-18
EPS — Category III	**SR Letter 15-19**
EPS — Category IV	**SR 12-7**
	SR Letter 16-3

Resolution planning	Governance
File resolution plans every 2 years	**FRB-Reg YY**
File resolution plans every 3 years	SR 16-11
Does not apply	**SR Letter 08-8**
	SR 12-17
	OCC heightened standards (only applicable to national banks)
	SR 21-3 / CA 21-1

Existing regulations **Incremental regulations**

Step 3:

Deploy strategic plan

Taking into account the strategic drivers, the central leadership group can deploy a plan that best serves its business model strategy. While many blueprints exist for executing a particular vision, some common strategic levers are provided below. Across each lever, leaders should be prepared to manage change and monitor the evolving landscape to ensure ongoing alignment with strategic objectives.

Examples of potential strategic levers

New entity launch

The ability to enter or maximize a footprint within a market, or to ensure resiliency, may require the establishment of a new legal entity, charter, or license. The current market, technological disruption, and economic conditions have spotlighted for financial institutions the importance of business model resiliency via access to stable deposit funding (for example, through banking deposits). As such, nonbank organizations such as financial technology (fintech) companies often seek to achieve business model objectives by developing and expanding capabilities via a bank charter or license. In addition to delivering access to new products, banks provide organizations with liquidity and access to a more resilient source of funds that is critical to stability during severely adverse economic cycles. Nevertheless, while a bank license may provide many unique strategic benefits, it also includes a complicated application process, increased operational requirements, and heightened supervisory expectations.

In certain cases, due to regulatory perimeter, licensing challenges, and restrictions, some nonbanks focus on offering traditional banking services, such as facilitating payments, holding deposits (or stored value in the form of wallets), and extending credit via banking-as-a-service (BaaS) solutions, working with a banking partner.

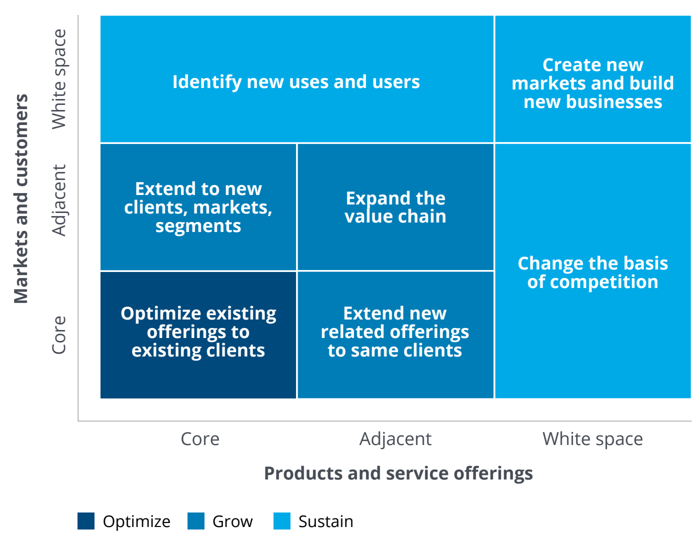
New product launch

Many organizations seek to achieve strategic objectives by accelerating growth via new product development, evaluating both organic and inorganic growth options and prioritizing opportunities based on consumer trends, emerging technologies, market attractiveness, and ability to win. Organizations that devote resources to creative product development (for example, a 0% interest loan rate or Small Business Administration Paycheck Protection Program loans) as a response to market conditions and evolving regulatory requirements can break into new customer segments and open new opportunities to cross-sell to their current base. In fact, emerging technologies, such as cryptocurrencies, blockchain, and artificial intelligence, have unlocked a new class of products and solutions. At the same time, greater reliance on digital wallets and contactless channels—together with more yield-seeking behavior by customers—provides an opportunity for fintech challengers to capitalize on their digital capabilities and low-cost structure to extend or tailor products to meet a broadening consumer demand. Whether a new entrant maturing into new products, a legacy organization addressing new segments carved out by fintechs, or a nonfinancial company looking to enter the financial industry, many growth paths and scenarios exist. Further encouraging various growth scenarios, regulators have shown a willingness to embrace innovation[1] and disruption within the financial system.

Ultimately, the financial industry remains in the midst of a product-offering arms race. Those best able to introduce and offer on a popular suite of products will be better positioned to capture this growing market.

Sample growth matrix

Using a growth matrix, organizations are able to evaluate markets, customers, products, and service offerings to identify opportunities to defend and drive revenue:



Digital banking

Changes in customer engagement methods have been significantly affected by shifts in the technological landscape coupled with transformative forces (e.g., artificial intelligence, digitization, innovation).

Financial organizations are leveraging the capabilities of their digital platforms to serve customers with the highest level of service, customer engagement, and personalization and to minimize brand or reputational risk while also looking to expand into new products.

Additionally, challenger banks—primarily digital-native entrants—and neobanks are rapidly gaining traction. Leveraging new digital solutions, artificial intelligence, and business models, these players have established a digital-first model with increased ability to adjust and thrive in the changing environment as a result of COVID-19. Artificial intelligence powered by a large data set is also an impetus changing the banking landscape for "digitally native neobanks." Unencumbered by the constraints of legacy business models and core systems, these new entrants can provide reimagined products and the type of simple and insight-driven experiences that digital-savvy customers expect. At the same time, established organizations are seeking to harness new technologies and tailor their digital strategy to enter new markets, acquire new customers, and prepare for alternative growth scenarios.

Riding the wave of the technological revolution, digitalization allows organizations to reduce costs, increase revenue, and attract new customer and market segments. It also allows organizations to meet the higher demands of today's consumer, who expects data-driven, user-friendly, contactless solutions with faster response times and a high-quality customer service experience. Organizations that find the right business model for the times and leverage tech and digital solutions to creatively and effectively meet consumer needs will be better aligned for success on the road ahead.

Legal entity optimization

Legal entity optimization is not a new topic, but it has received greater attention due to the challenging economic landscape and increased costs related to regulatory compliance in the United States. These factors are compelling organizations to explore strategies for streamlining their business structures, reducing resource-intensive burdens. The current industry landscape is characterized by a proliferation of entities and increased organizational complexity. In addition, regulatory arbitrage has led organizations to employ different tactics in different jurisdictions. As a result, executives should reassess their organization's current legal entity footprint to realize the greatest benefits from changing rules and regulations, such as US tax reform and deregulation. Furthermore, as regulatory requirements and tax constraints evolve, financial institutions may be under less pressure, opening up new opportunities to expand and grow business in other markets. Merging with and/or acquiring other businesses is one means of achieving long-term strategic goals.

Booking model optimization

As an organization expands, it faces new regulatory requirements, or changes its operating model, legal entity, and operational structures, as well as its booking models, which requires an evaluation to ensure they support the evolving business strategy and regulatory expectations. As organizational structures become more inflated, opportunity exists to increase earnings by decreasing the top line. Booking model processes can help leaders achieve a wide range of strategic objectives. An organization's booking model defines how and where it transacts and how the resulting risk is managed and governed. While often shaped by regulatory pressures and geopolitical circumstances, an organization's booking model is also a manifestation of its business strategy. Recently, post-financial crisis, and more recently through Brexit, individual regulatory bodies have published explicit expectations for booking models (e.g., Basel Committee on Banking Supervision's 2023–2024 strategic priorities include an explicit reference to "horizon scanning exercises" on cross-border booking models, the execution of which will likely require coordination with prudential regulators).

Booking model objectives include legal entity simplification, reorganizing entities and businesses for more effective capital strategies, enhancing risk management through entity and risk realignment, and driving cost synergies by liquidating entities. In optimizing their booking models, executives should reevaluate and prioritize their financial, operational, and strategic goals while keeping in mind the current regulatory landscape, business needs, and competition.

Organizations are required to shift their focus on how legal entities are utilized to access markets, face clients, manage resulting risks, and to ask questions (e.g., How should branches be utilized vs. subsidiaries? Have recovery and resolution planning implications been factored in? Have capital, tax, liquidity, and compliance/operational risk implications been considered?).

Step 4:

Select execution method

The central leadership group should assess its current state and determine the most effective and efficient method for executing its strategy. The approach should allow the business to expand while also remaining within regulatory thresholds and maintaining, or even improving upon, business operations and processes. Some considerations while undergoing this process include understanding explicit impacts on the business and minimum capabilities required to successfully operate and achieve sustainability.

While several options exist, merging with and/or acquiring other businesses is a common option to pave a new path forward to achieve long-term strategic goals. Mergers and acquisition (M&A) is a solution that provides an opportunity to not only enable your organization to optimize assets and bank earnings, but also reevaluate the business brand and objectives to continue to establish its footprint and services, both nationally and globally. Furthermore, executives may view M&A as an opportunity to acquire innovative capabilities. M&A has gained momentum due to the Volcker rule[2] simplification and tax reform legislation. With this change in requirements, bank stakeholders can focus their time, effort, and funding on expanding in current or new markets.

As part of execution, the central leadership group also needs to oversee the change management process. This includes the integration of new processes, products, and legal entities into the fabric of the organization in a way that ensures the success of strategic objectives. While execution of any particular strategy may be a one-time event, the exercise of change management oversight should be an ongoing activity that becomes ingrained within the organizational culture. By acknowledging the organization's evolving nature, the central leadership group will be positioned to ensure ongoing business model success.

Deloitte can help you develop your integrated view

Whether it is through the lens of creative product development, response to new regulatory requirements, emerging technologies, acquisition of innovative capabilities, or enhancement of existing operations, these catalyst shifts present leaders with various means through which to optimize their business model. With so many considerations at hand, banks and other entities may choose to look outside their organizations for assistance with crafting strategy, implementing technology, and navigating regulatory nuances. Deloitte remains well-positioned to help financial services clients achieve their strategic objectives during these uncertain and evolving times, as well as to help them prepare for the future. We combine our breadth of knowledge and experience, as well as a suite of industry-tested tools and accelerators, into a broad approach to business model strategy to help guide you through this future-defining process.

Step 5:

Execution considerations

The central leadership group should assess the dynamic regulatory landscape and evolving economic conditions in order to effectively implement the established strategic framework. Within this context, several considerations should be taken into account to ensure compliance with regulatory requirements and long-term sustainability.

Legal entity capability management

Legal entity required capabilities depend on the license and regulatory set-up. Non banks will face lower expectations as a result of state regulatory regimes.

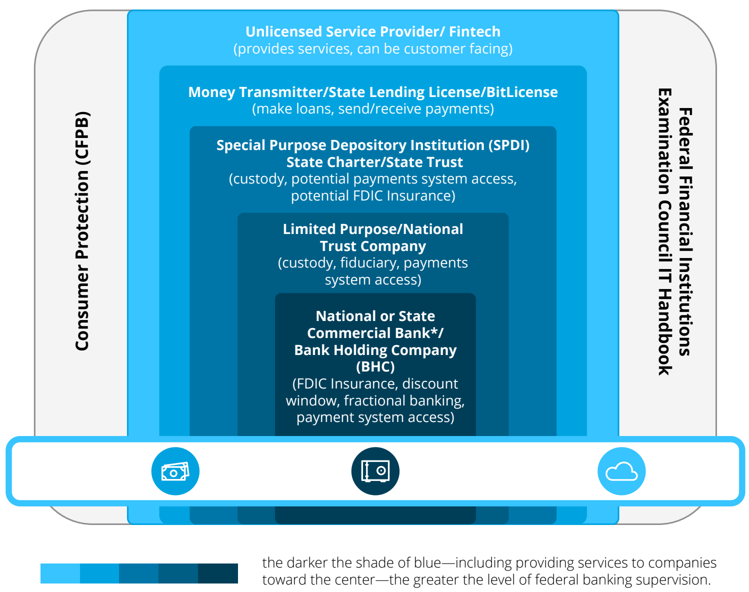
The “bank” regulatory perimeter

Explanation of the regulatory perimeter

The regulatory perimeter consist of the boundaries of the various federal and state regulatory and legal frameworks that apply in different ways to different types of financial institutions and financial services offerings.

The darker the shade of blue—including providing services to companies toward the center—the greater the level of federal banking supervision (OCC, FDIC, FRB)

To a large degree, digital asset disruptors are testing the bounds of the regulatory perimeter and fueling the discussion about the proper reach of federal and state regulatory authority and control.



US regulators’ expectations for banks for enhanced prudential standards, newly proposed standards under Basel III, and TLAC requirements are triggering changes to banking institutions’ thresholds and requirements (e.g., implementation impacts for Category III and IV banks as requirements are aligned with the largest banks[3] [operational and credit valuation adjustment risk, dual risk-weighted asset requirement, countercyclical capital buffer, and supplementary leverage ratio]). As organizations increase complexity and asset size, they are subject to increased regulatory requirements. Especially following the recent bank failures, we expect heightened regulatory scrutiny on the fundamentals of banks’ business models and risk management programs, including appropriate design, day-to-day management, and issue escalation. Banks with a higher-than-average number of remediation issues, significant growth profiles, or idiosyncratic business models can expect more regulatory focus.

Organizations should pay particular focus to the risk and compliance capabilities of their regulatory engagement management, regulatory policy, and regulatory change functions. Additionally, banking institutions should anticipate an overall increase of capital levels across the industry and significant implementation burden related to the Basel III proposal and long-term debt requirements for banks with greater than $100 billion assets, enhanced resolution plan requirements, and supervisory instructions on funding concentrations related to high levels of uninsured deposits.

Contact one of our business model strategy specialists to learn more about how your organization can help you redefine success and win in the marketplace.

Learn more

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Endnotes

1. FDIC Innovation Office; Office of the Comptroller of the Currency (OCC) Innovation Office; US Securities and Exchange Commission (SEC) Innovation Office; Board of Governors of the Federal Reserve System (FRB) Innovation Resources.

2. FRB, Volcker Rule, last updated January 30, 2020.

3. Alok Sinha et al., "US Basel III Endgame: Key changes, impacts and where to begin," Deloitte, August 2, 2023.

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