Dealing with divergence

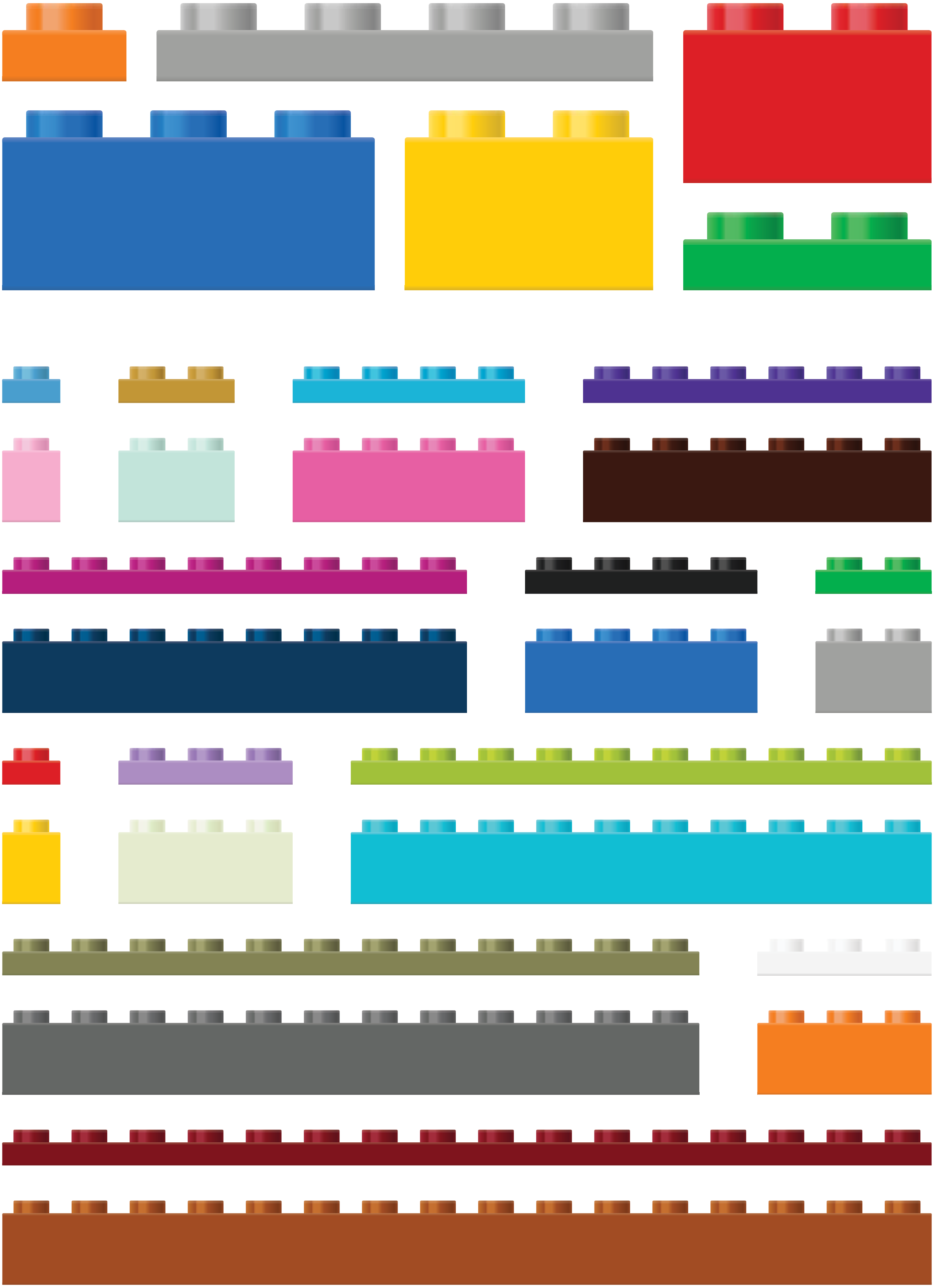
How banks can build a strategic response to the uneven implementation of Basel standards

David Strachan
Partner
EMEA Centre for Regulatory Strategy
Deloitte UK

Scott Martin
Senior Manager
EMEA Centre for Regulatory Strategy
Deloitte UK

Since the Pittsburgh G20 Summit in September 2009, regulators around the world have been committed to strengthening capital, liquidity, and leverage standards for banks. The agenda is well-known; embedded within it has been an equally strong commitment to addressing the unevenness and complexity of the global capital framework for internationally active banks. Regulatory convergence initiatives such as Basel III were intended to pave the way for an increasingly consistent banking rulebook in most jurisdictions. This drive to increase regulatory convergence is now under pressure. Almost 10 years on from the onset of the financial crisis, and with governments keen to stimulate economic growth, there are signs of "regulatory fatigue" setting in, and several countries are questioning the need to adopt additional common global regulatory standards for the banking sector.

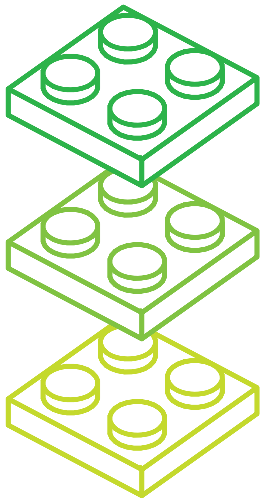
The European Union's approach to Basel implementation in the last year has been instructive. Although in the past it has been prepared to amend international standards to reflect European specificities, the European Commission's November 2016 proposed review of the Capital Requirements Directive and Regulation (CRD V/CRR II) demonstrated a growing willingness to depart from an implementation of global post-crisis banking rules either in full or on time. This was particularly evident from the proposed implementation of the Basel Committee on Banking Supervision's (BCBS's) Fundamental Review of the Trading Book and Net Stable Funding Ratio. The time it now takes for EU institutions to pass major banking legislation alone indicates that similar timing departures are in store for the implementation of Basel III's remaining elements (often referred to as "Basel IV"). In short, the global regulatory landscape for banks looks set to become increasingly divergent and fragmented and the implementation of Basel III is becoming a prime example.



Why internationally active banks should be concerned

Left unchecked, these developments will have very real implications for banks with substantial operations in multiple jurisdictions. Many regulators will hope that December's international-level agreement on Basel III will draw a line under the post-crisis regulatory agenda, but the inconsistencies arising from jurisdictions charting their own course in implementing it may substantially increase the complexity faced by regulatory and risk managers at these banks.

This added level of complexity will multiply the costs and challenges already associated with more manageable levels of regulatory change. This will, in turn, generate substantial pressure to increase headcount, will demand more cumbersome processes requiring more frequent manual intervention, and may complicate the understanding of the future state capital, liquidity, and risk environment. We believe this could significantly increase the risk of strategic paralysis for banks as they struggle to assess the cumulative impact of regulation on the profitability of their products and services and operate without a clear understanding of their costs and binding constraints. As a result, they will be less well-equipped to make the best business and resource allocation decisions. In our view, the challenges associated with regulatory divergence give rise to three types of questions, which the management and boards of internationally active banks should consider as a matter of urgency.



Strategic: Does divergence affect the sustainability of business models and the ability of managers to plan and make well-informed regulatory and business decisions?

Operational: To what extent an inconsistent Basel III implementation increase the complexity and costs of risk processes, and can bank governance structures, controls, and regulatory capabilities cope with this complexity?

Technological: How will divergence increase the pressure on banks' data management systems and do these challenges strengthen the case for making additional IT capability investments?

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The blueprint for a strategic approach

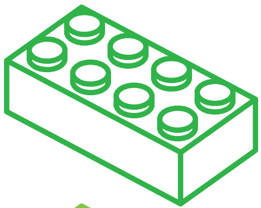
These strategic, operational, and technological considerations, in our view, further justify the case for banks to make targeted investments now to enhance their risk management and regulatory strategy capabilities in order to operate more efficiently in an increasingly fragmented environment.

We call this developing a "divergence-resilient" approach to regulatory complexity, and we believe that the risk of a fragmented implementation of Basel III makes a greater business case for such an approach now more than ever.

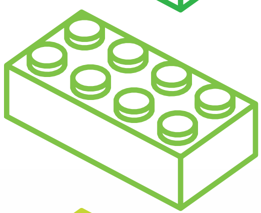
Our view is that regulatory technology (RegTech), which is becoming increasingly available, can allow such a divergence-resilient approach to be designed flexibly enough to control for the uncertainty around Basel standards that can still be modified by national legislatures and regulators. As part of this, there are a number of capabilities that banks can develop or extend to support ongoing risk and regulation processes, most notably stress testing and capital planning.

For most banks, this will require a significant re-thinking or acceleration of changes to their regulatory operating models, which may nevertheless take years to fully implement. Such models, however, would not only help enhance the functionality of banks' regulatory processes, but also transform the way that they integrate regulatory and commercial considerations—what we see as the real crux of "regulatory strategy." This will allow them to manage their risk and regulatory capital operations more centrally, embed the multiple demands they face into routine scenario planning, and produce more meaningful information on the costs of capital and liquidity to enable better business decisions.

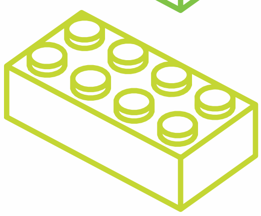
In order to support the development of regulatory strategy capabilities, the core elements of the divergence-resilient approach that we propose include:



Making targeted investments in **technology, data, and modelling** to allow risk and regulatory processes, such as capital calculations, to be conducted more quickly and cost-efficiently



Aligning **governance structures** and regulatory processes to support greater flexibility and functional integration; for instance, greater risk and finance alignment for capital planning and stress testing purposes has yielded strong dividends for many firms



Developing a new or enhancing an existing **central regulatory strategy group** with the mandate and analytical capabilities to assess the impact of Basel standards—both those in force and those forthcoming, and related divergence—on business strategy and profitability.

A divergence-resilient approach to managing regulatory complexity

Regulatory strategy capabilities

Central regulatory strategy group
A central function responsible for identifying the bank's current and future regulatory demands, interpreting the need for resources this will create, identifying and in some cases directing investments in technology, data, and governance needed to support the divergence-resilient approach and providing regulatory insights for business strategy planning.

Scenario-based analytical capabilities
Embeds an ongoing process of scenario analysis that provides a more granular understanding of the impact of forthcoming or probable regulatory developments. When mature, the use of data analytics can eventually provide a deal-by-deal view of the likely regulatory costs to the business and identify optimal strategies.

Enhancing core functionality

Technology, data and modeling
Investing in technology, modeling and data remediation to enable capital and liquidity calculations and controls to be varied in a short period of time. Allows for the greater use of robotic automation to reduce the time and cost-intensity of regulatory processes.

Governance and operating model
Creating clear responsibilities, processes, and lines of communication to facilitate quicker and more flexible risk management capabilities. Includes executive-level sponsorship of the divergence-resilient approach and intervention, where needed.

Thinking further ahead

For most internationally active banks, maximizing profitability while also contending with multiple regulatory constraints on the allocation of capital is an increasingly challenging task. Combined with the never-ending imperative of reducing costs, the temptation to take a piecemeal or tactical approach to regulatory capital management, as opposed to an integrated and strategic one, is strong. However, given the trend toward regulatory divergence and the already foreseeable delays in the implementation of Basel III, we believe that a minimalist approach could set banks on a medium-to-long-term course toward incurring higher costs arising from an increasingly complex regulatory landscape.

Greater divergence in the eventual implementation of Basel III's final components also threatens to undermine the confidence that regulators and supervisors have in each other's efforts to manage risk in the banking sector. As a result, reduced trust between a bank's home and host supervisors could cause hosts to take further measures to ring-fence the capital and liquidity resources of banks in their jurisdictions. This has already been seen with the Intermediate Holding Company requirement in the United States and the EU's similar Intermediate Parent Undertaking proposal. These developments run the significant risk of creating even greater trapped pools of capital and liquidity than already exist in the global banking market.

Developing regulatory strategy capabilities to deal with this will be neither simple nor cheap. But regulatory spend to enable more efficient capital and liquidity management should not be viewed as a "deadweight cost" that adds little value to the broader business. It is clear that Basel III's requirements have emerged as some of the most decisive regulatory variables for a global bank's profitability since the financial crisis. The capabilities, flexibility, and foresight gained through a divergence-resilient approach to dealing with regulatory fragmentation can support commercial decision-making and ultimately contribute to the creation of a more sustainable business model. From this perspective, we consider that the case for such an approach, which generates a positive return on investment, is to be made. Looking ahead to the prospect of an increasingly uneven and unpredictable implementation of Basel III underlines this urgency.

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