Business model implications of global regulatory requirements

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Financial services firms face challenges to their business models from a potent mix of low interest rates and low economic growth, higher operating costs and complexity, and heightened competition including as the result of technological innovation. In Europe, some banks in particular face the additional problem of working through large portfolios of non-performing loans. One consequence has been persistently lower profitability, and downward revisions to profitability targets. Against this backdrop, many firms are still grappling with the task of demonstrating a business strategy that delivers sustainable future returns.

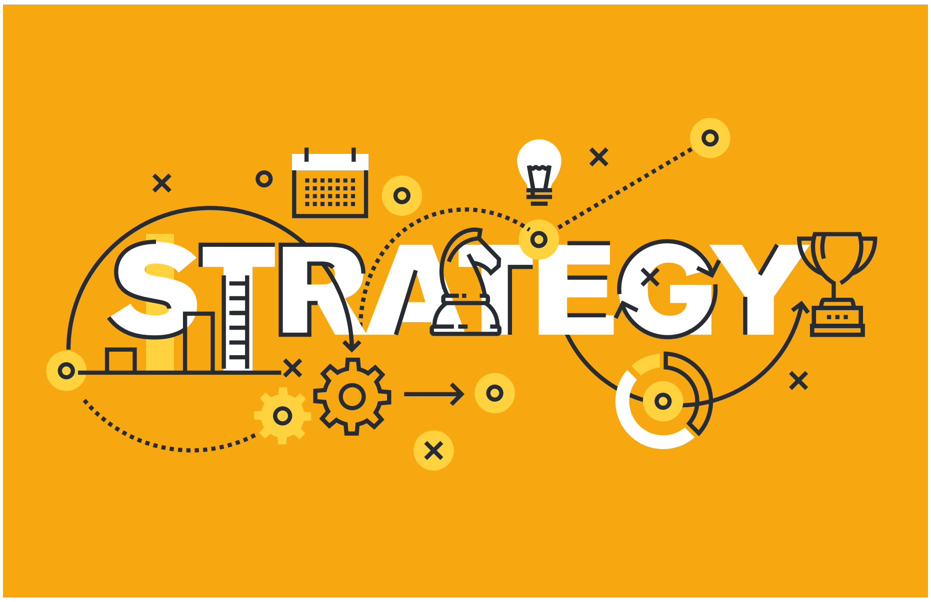
Among the factors driving these challenges is the wave of new and proposed regulations that financial services firms face. Although the global financial crisis that triggered this wave began nearly a decade ago, regulatory change persists across the financial services industry.

Challenges from regulation manifest themselves in a number of ways. The task of implementing new requirements is invariably costly, and in general, compliance costs are higher post-implementation. Planning for and managing regulatory change projects also divert senior management's time and resources from other initiatives that a firm might want to pursue. In this article, we specifically consider the implications of regulatory change for business strategy. The immediate implications crystallize where new regulations impede existing business activities, for example through the introduction of additional costs, or by prohibiting certain activities. The even greater challenge is to understand the effect at a cross-business line or group level, across all of the changes being made—and to re-optimize the business model in light of the new constraints.

The regulatory framework remains unstable and difficult to anticipate, more so in recent months as efforts to finalize certain initiatives have brought to the fore the fact that some outstanding aspects to be agreed remain quite controversial.

1. This article draws on discussions with colleagues across Deloitte's global network of Member Firms, but in particular benefits from the input of Christopher Spoth, Richard Rosenthal, Alex LePore and Prateek Saha in the Deloitte Center for Regulatory Strategy North America.

The number, inter-connectedness, and complexity of regulations contribute to the difficulty of this task. The regulatory framework remains unstable and difficult to anticipate, more so in recent months as efforts to finalize certain initiatives have brought to the fore the fact that some outstanding aspects to be agreed remain quite controversial. Some of those elements where uncertainty remains are crucially important to determining the ultimate implications of the regulations for firms—the finalization of the remaining elements of the capital regime for banks is one example. Beyond those issues, to the extent that there has been any let up in the widening reach of regulation, there is increasing detail to be managed and assessed.



Sector implications

As an example of how these factors play out, for life insurers the low interest rate environment and its transmission through the Solvency II regime is exerting an increasingly powerful influence on business models. The current design of the Solvency II risk margin amplifies the balance sheet volatility effect of low interest rates, and increasingly incentivizes insurers to reinsure longevity business that is not covered by transitional Solvency II arrangements. The longer term regulatory response to this trend is uncertain, but among other responses it is likely to lead to greater supervisory scrutiny of insurers' risk appetites, governance, and controls in the reinsurance area. As low bond yields incentivize shifts in the portfolio mix of investments, supervisors are also likely to sharpen their focus on board oversight and understanding, and the quality of credit underwriting controls and monitoring. It is also possible that this trend, if adopted by a group of firms, attracts attention from regulators because of concern about risk concentration.

Business models of investment managers are under less extensive regulatory pressure. However, there is increased regulatory and supervisory focus on ensuring value for money for customers across the product value chain. In addition, increased transparency on costs and charges, strengthened inducement rules, and rules on unbundling of dealing commissions will mean investment research costs, fund management charges, and distribution costs will all be under pressure. Investment managers will be seeking more cost-effective and direct distribution channels, including increased use of automated financial advice.

The challenges though are currently the most acute for banks. Final calibration of the Basel III international regulatory regime is a case in point. Although the Basel Committee on Banking Supervision (BCBS) has committed to not significantly increase overall capital requirements with its latest reforms, Chairman Stefan Ingves acknowledged in 2016 that "it is inevitable that minimum capital requirements will increase for some banks."[2] Those changes come on top of a significant increase in the capital base and funding requirements for banks through reforms that have already been implemented.

More importantly for the assessment of business strategy, the overall prudential framework for banks is now very complex, with multiple initiatives driving changes to certain aspects of banking, or multiple constraints being introduced for certain activities.

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2. Stefan Ingves, Chairman of the BCBS and Governor of Sveriges Riksbank, quoted in a press release accompanying publication of a proposal from the BCBS on revisions to the operational risk framework, 4 March 2016, available at http://www.bis.org/press/p160304.htm.

For example, the BCBS's Fundamental Review of the Trading Book (FRTB), the design of new internal market risk models, and a new mandatory standardized calculation will have a substantial impact on market risk-weighted assets; at the same time, IFRS 9, a revised accounting standard that determines how banks should classify and measure financial assets and liabilities, requires loan loss provisions based on expected credit losses instead of incurred losses; and the BCBS is considering the introduction of floors for risk-weighted assets. These changes all affect the calculation of risk-based capital—and in turn the per unit regulatory charge for risk. At the same time, banks have to tackle supervisory stress-testing initiatives and more intensive supervision—which both in practice tend toward a more conservative appetite for risk.

To illustrate the challenge of multiple constraints, consider a bank deciding whether or not to make a new loan to a customer. The loan will attract a capital charge under both the risk-weighted capital ratio and the leverage ratio, and the funding of the loan will be captured by two new regulatory liquidity ratios, a measure of short-term liquidity (the Liquidity Coverage Ratio), and the longer-term balance of maturities between assets and liabilities (the Net Stable Funding Ratio). Moreover, the commercial viability of the lending decision will be determined not just by this myriad of ratios over the course of the term of the loan under a baseline scenario, but also under stress. For internationally active banks, rules requiring the ring-fencing of certain activities or legal entities affect the fungibility of capital and liquidity across the group, further complicating the picture.

Sustainability of bank business models

Left unchecked, the accumulation of these regulatory changes will reduce strategic flexibility and efficiency. This point applies most immediately to banks, but other financial services firms can draw insights from how banks need to understand the challenge and the tools they need to develop to deal with it.

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In our experience, too few resources have yet been deployed for this strategic analysis. Many banks have—understandably—approached the implementation of regulatory changes by focusing on the immediate task of meeting compliance deadlines. Where there has been an assessment of the implications of regulation for business models, it has more often focused on a subset of business lines rather than the bigger picture.

This experience holds across the banking sector. The Financial Stability Board's most recent annual report on the implementation and effects of global financial regulatory reform notes that banks are "still in the process of adjusting their structures and business models in response to the new operating environment, in search of sustainable profitability."[3]

What is more, business models are under ever-increasing supervisory scrutiny. In the UK, Sam Woods, CEO of the Prudential Regulation Authority (PRA), said recently that it was "too early to say how business models will shape up in the future…many banks have simply not yet adapted to the new prudential constraints or the lower-rate environment."[4] For the European Banking Union, Sabine Lautenschläger, Vice-Chair of the Supervisory Board of the ECB, has noted that "from [the perspective of the ECB] as supervisors, the viability of business models is currently one of the main points of attention…[supervisors] are not only scrutinizing business models and profitability drivers, but are also taking a close look at risk management."[5]

Business model analysis is a core component of the supervisory risk assessment framework in the forward-looking, judgement-based approach now commonplace for banking supervisors across the European Union. Supervisors expect banks to develop and integrate a stronger understanding into their management approach, as well as an analysis of business strategy in the new operating environment, including how their business compares to that of peers. After hinting at it in the past, supervisors will also start to pay increasing attention to the coherence and integration of business strategy across stress testing, recovery and resolution plans, and individual capital and liquidity adequacy assessments, and the consistency with a bank's risk appetite framework.

Banks need to invest in developing new capabilities

The changes that banks need to make go beyond giving a nod to regulation in strategic discussions—their whole approach to understanding and responding to the implications of regulation for business strategy decisions needs to evolve. Banks need an approach that is comprehensive, forward-looking, and analysis-driven.

To prioritize investment in this area, banks should begin by benchmarking their current capabilities and requirements—the tools that they have available, and the issues and scope being assessed—across modelling, stress testing, capital and liquidity planning, financial planning and data, and taking account of people, technology, and governance. (The data question is in fact often the "elephant in the room," and will likely need to be addressed as part of the solution if the analysis is to be sufficiently grounded in the reality of the business.)

The best way forward for a bank will depend on the current state of its capabilities, and the complexity of its business. The elements to consider include:

- **Balance sheet optimization:** Many optimization approaches in the past considered only part of a bank's portfolio, or else pre-dated the myriad constraints now present in the regulatory framework.
- **Top-down modelling:** Banks need to be able to run a scenario analysis to consider the interaction between regulations and strategy decisions, but existing tools are typically too granular and cumbersome. A key decision will be the granularity of the balance sheet and income statement, informed by the specific business lines, model capability, and strategy of the banks.

These factors can ultimately be brought together, but in the near-term it is helpful to consider them separately. Data visualization, and the ability to run both static (point-in-time) and dynamic (including incorporating future regulatory changes) analysis should be considered as components of any solution. Decision-makers can then use the tools to do on-the-fly "what if" analyses showing the impact of their strategies and actions on a variety of past, present, and future business scenarios. The perspective then needs to be embedded in the way that the senior management team drives the business forward.

With many competing demands on resources, banks might think it simpler to prioritize those with nearer-term deadlines and more specific outcomes than the capabilities we have set out here. However, without investment in their ability to understand and assess their business strategy, banks will ultimately find themselves at a strategic disadvantage to peers, and on the back foot in conversations with supervisors.

3. Financial Stability Board, 'Implementation and effects of the G20 financial regulatory reforms,' 31 August 2016, available at http://www.fsb.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms.pdf.
4. Speech made by Sam Woods, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority, Bank of England, 'The revolution is over. Long live the revolution!', at the City Banquet, Mansion House, London, 26 October 2016, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech933.pdf.
5. Speech made by Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, 'The European banking sector – a quick pulse check,' at a Euro Finance Week Conference, Frankfurt am Main, November 15 2016, available at https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se161115.en.html.

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