Legal entity and booking model optimization

Why global banks and capital markets organizations are re-assessing strategies

Center *for* **Regulatory Strategy** **US**

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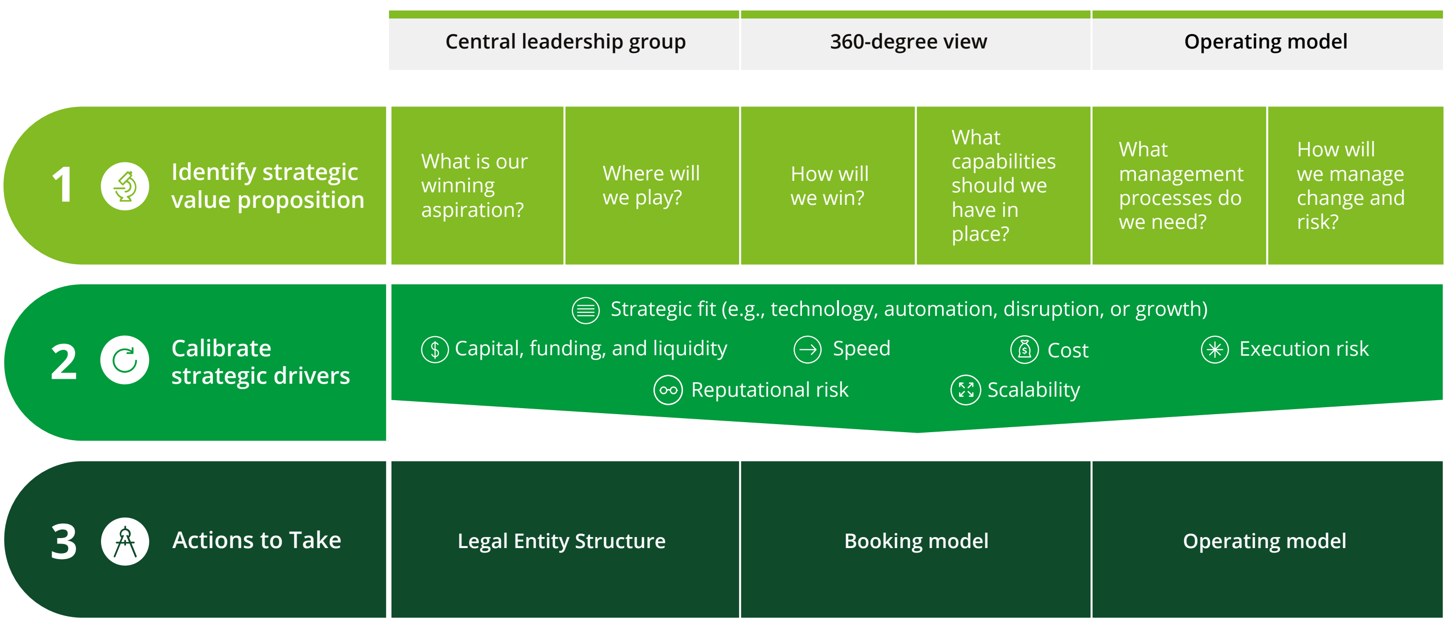
The stability of the banking system experienced a recent shock largely due to concerns around interest rate risk management practices and liquidity mismatches, together with a loss of market confidence in certain large institutions. During such times of distress, it is even more important that regulatory bodies across the globe have a clear understanding of the risks global firms pose to their respective jurisdictions, which largely crystallize through the legal entities they supervise and the relationships those entities have with internal and external counterparties.

Notwithstanding these recent events, financial regulators have continued to increase expectations for legal entity-oriented governance and risk management. Firms have been required to embrace a deeper understanding of their "booking models," i.e., where, and how financial instruments are originated and booked, the underlying drivers and rationales, and how any residual risks are managed across the legal entity structure. We expect this focus to heighten materially in the coming years.[1] Our previous article, "Global bank booking models: Maximizing and maintaining the business benefit," discussed the impacts of supervisory developments on booking models amid evolving regulatory requirements.[2] Many of our observations in that article remain true today.

Whilst booking model governance and controls remains a priority for many regulators and the firms they supervise, there are further internal drivers for organizations to re-assess and challenge long-standing, legacy legal entity structures and booking practices. As interest rates continue to rise, and both funding and operating cost pressures increase, there is a renewed focus on how firms deliver return on equity (RoE) goals with clear and focused business models that optimize financial resources.

Figure 1. Business model strategy



The booking model provides several firms with opportunities to realize simplification benefits, lower the cost base, optimize capital and liquidity, and enable a more streamlined approach to governance and risk management. For other firms, the booking model also provides an opportunity to increase revenue generating capacity and provide a greater breadth of products to clients across the globe. Given this combination of external developments and internal drivers, we are observing a number of firms revisiting their legal entity structures and booking models through an optimization lens.

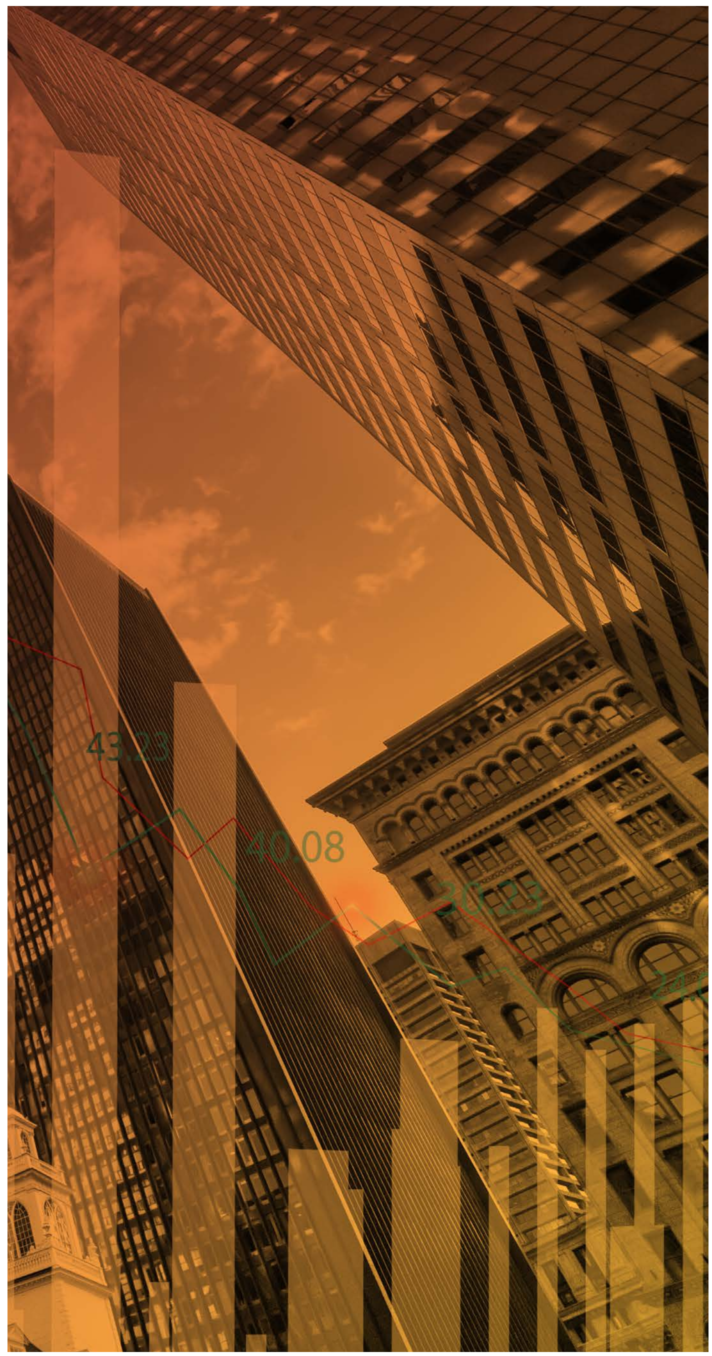
What are the key considerations to optimize legal entity structures and booking practices?

Several legal entity structures and booking practices remain a byproduct of legacy acquisitions, tax structures, technology, and infrastructure considerations, together with one-off client preferences. Ad hoc rationale supporting legal entity structures and booking model decisions typically result in a fragmented model, which often includes duplicative operating practices and leads to enhanced regulatory scrutiny. In certain instances, this has resulted in multiple bank or broker-dealer subsidiaries in a single operating jurisdiction, without there being a clear regulatory requirement to do so.

Optimization considerations may have been evaluated previously and in a different market environment and should be reassessed to confirm that there are no unintended consequences from proposed enhancement initiatives. The breadth of considerations is significant and typically requires the input of multiple skillsets to capture and model the impact of potential legal entity or booking model change across a range of dimensions:

- Regulatory
- Client
- Capital and liquidity
- Operating model (including infrastructure)
- Risk management and governance

In addition, firms should consider the implementation requirements to achieve their target state, including the cost, complexity, and execution timelines to verify that any actions taken make commercial sense. Finally, regulatory horizon scanning is paramount in order to ensure that the target state is reasonably "future-proof."



How are regulators thinking about booking models, and what are the focus areas?

Strategies to optimize booking models require a comprehensive understanding of regulatory requirements and perspectives in all relevant operating jurisdictions. Regulators have approached defining expectations and supervising booking models in different ways, making it even more important for organizations to conduct a thorough assessment before investing and executing any booking model optimization strategies.

Post financial crisis, and more recently through Brexit, individual regulatory bodies have published explicit expectations for booking models, including the Board of Governors of the Federal Reserve System (FRB),[3] the Federal Deposit Insurance Corporation (FDIC),[4] the Prudential Regulation Authority (PRA),[5] and the European Central Bank (ECB),[6] with broader global standard-setting bodies such as the Basel Committee on Banking Supervision (BCBS) now also placing further emphasis on the topic. The BCBS'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.[7] Several important cross-jurisdictional considerations are relevant, including the differences in supervisory perspectives, resolvability, ring-fencing, home and host-country prudential frameworks, and derivatives regulation and market access requirements.

While regulators have differing levels of guidance and ways in which they raise concerns, there are now baseline expectations across jurisdictions that should inform any booking model strategy:

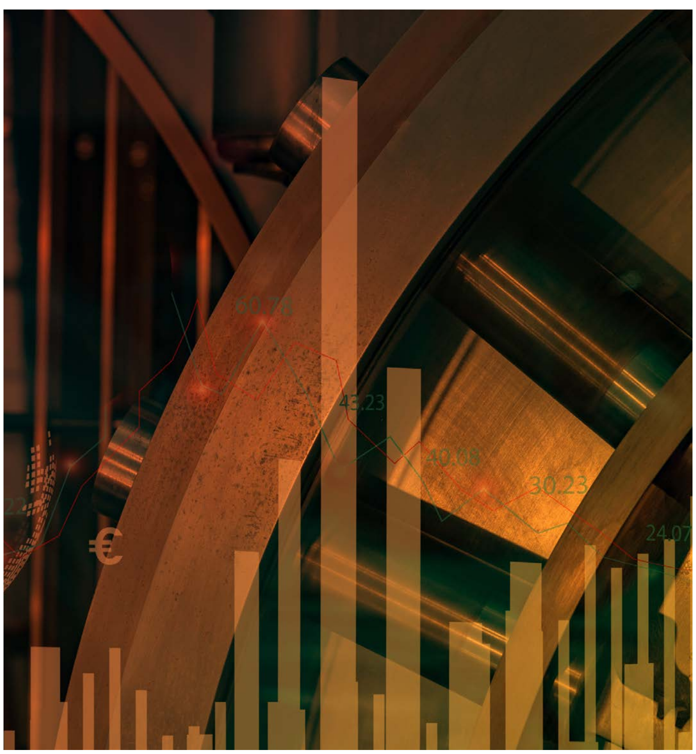
- A rational and well-understood booking model with clearly documented permissible booking practices
- A risk-based approach to implementing preventive and post-trade controls, calibrated to permissible booking practices, with robust risk management approaches for each booking entity
- Tailored oversight, controls, and management information to manage the additional risks associated with intra-group relationships, including remote booking or intra-group risk transfers
- Inter-entity services are appropriately captured and underpinned by relevant agreements and financial arrangements (including revenue and expense allocation commensurate with the inbound and outbound activity)
- Embedded governance and accountability frameworks supported by local risk management capabilities
- Effective management information that covers the complexity of the booking environment and addresses individual transactors, products, counterparties, and the magnitude of risk on a legal entity specific basis

How to get started

The optimization process usually begins with ensuring there is clarity over the strategy of the organization (products/markets, clients, operating locations). A set of design objectives (e.g., reduce intercompany exposures, consolidate market risks, reduce funding costs) typically guides how the organization should operationalize the new or revised booking model strategy. This typically serves as an anchor and provides cross-functional stakeholders (across the business, risk, finance, tax, legal, compliance, and regulatory functions) with a framework for assessing emerging strategies against consistent target-state design criteria.

The legal entity structure: Based on the strategy of the organization, it is critical to understand the entities required to enable business objectives.

- Which legal entities, including regulated bank subsidiaries, broker-dealers, and branches are required in operating jurisdictions? Does duplication exist? What is the minimum required footprint?
- What key regulatory constraints exist (e.g., US bank separation rules, registration and licensing requirements, local restrictions)?



- How are host country versus home country regulatory and supervisory considerations taken into account (e.g., foreign banking organizations' US operations versus US domiciled organizations)?

The booking model: After a review of which legal entities are needed, focus shifts to how these entities are utilized to access markets, face clients, and manage resulting risks.

- How should branches be utilized vs subsidiaries?
- Is market risk management centralized to the extent possible?
- Which entities take on credit risk and face customers? Are they supported by the requisite internal model approvals for the calculation of risk weighted assets (RWA)?
- Have capital, tax, liquidity, and compliance/operational risk implications been considered?
- Have recovery and resolution planning implications been factored in?
- What is the impact on clients, including potential repapering requirements, as well as the organizations' ability to meet client needs (e.g., breadth of product offering, netting and margining considerations, time zone, legal jurisdiction)?

The operating model: The last pillar to review after legal entity structures and booking models have been defined is the supporting operating model.

- Where should sales, trading, control functions and senior management be located?
- What technology is required in each booking or risk management entity?
- Is the current model heavily reliant on tactical solutions as a result of recent booking model changes (e.g., in response to Brexit or other local jurisdiction requirements)?
- Are firms deploying an optimal mix of onshore, nearshore, and offshore resourcing models?
- Is the current model aligned with evolving regulatory expectations (e.g., the European Central Bank expects that firms will strengthen their EU capabilities)?
- Could the operating model benefit from a potential service company entity structure?

In conclusion

Regulatory requirements may dictate where certain activities are booked, and risk managed. However, firms still have discretion to define a range of preferred legal entity and booking arrangements provided they can evidence that regulatory, customer, capital, and other driving factors have been accounted for in the decision-making process.

As a starting point, we recommend firms work to clearly understand and document their current minimum legal entities and branches required to service clients and access market infrastructure in alignment with their business strategy. Next, we suggest that firms develop and pressure-test optimization hypotheses, evaluating each against quantitative and qualitative considerations to enable the informed definition of a target state. Engaging a broad range of functions and senior management stakeholders is critical to ensure the target state, and journey for getting there, is bought into and all considerations have been thoroughly evaluated to ensure "no regrets" actions.

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Endnotes

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3. Board of Governors of the Federal Reserve System (FRB), "Living Wills (or Resolution Plans)," last update March 14, 2022.
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