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EU Financial Services Outlook 2015

February 2015

Abstract

Over the next 12 months the transformation of the financial services industry is set to continue to accelerate. Since the financial crisis, firms have focused on rebuilding their balance sheets and implementing new regulations, designed to strengthen standards for a simpler, safer industry. Regulatory change is set to continue through 2015 and beyond, but firms increasingly have to also contend with new commercial challenges in the face of decreasing margins, disruptive technology and new market entrants. This paper sets out our view on some of the key challenges for firms in 2015 across three key areas:

- **Regulatory Change** – The continuing challenge to remain compliant with new, tougher regulatory requirements.
- **Digital Transformation** – The disruption of existing business models by technological innovation.
- **Business Optimisation** – The challenge to reduce costs and protect margins and market share in the face of increasing regulatory and capital costs, plus competition from new market entrants.

All told, 2015 is going to be an interesting year. We hope it is also prosperous for you.

Regulatory Change

Given the pace of regulatory change over the last 5 years, firms can be forgiven for feeling a degree of regulatory fatigue; however, the journey is not over and the rate of regulatory change continues unabated.

Although, in some cases (Basel 3, MiFID 2, Volcker, Recovery & Resolution) high level regulations are now agreed, detailed implementing regulation and technical standards are still being discussed, implementation dates are shifting, making it extremely challenging for firms to implement the changes in line with the tough timescales being imposed.

In other cases, high level regulations are still being drafted and, while specific requirements remain opaque, firms are at least able to plan change activities to analyse, lobby and implement changes as they emerge.

Perhaps most problematic for firms are the unexpected changes, either arising from specific failures (e.g. benchmark abuse) or unexpected legislative changes by national regulators not always in line with EU decision making processes. Regulators continually shift their expectations and areas of focus in line with the risks they perceive in the market and firms need to retain sufficient flexibility in their change agendas and budgets to respond to these "black swans".

Against this backdrop, we've set out below some of the key regulatory challenges that we anticipate will demand firms' attention during 2015.

BCBS 239: Principles for Risk Data Aggregation & Risk Reporting

Adherence to the BCBS 239 principles offers clear benefits for banks, yet implementation continues to present challenges, hampered by outdated and fragmented systems, manual processes and poor data quality. Currently, the response to BCBS 239 is primarily IT led; however the reality is that delivery of complete, accurate and timely data may not enhance the decision-making process, if that data is not being converted into actionable information. The fundamental challenge for risk managers remains how to present the right information to the relevant audience at the right time and in an easily understandable way in order to facilitate effective decision making. Therefore, the ideal solution for BCBS 239 should equally focus on governance, risk processes and end user experience as well as data aggregation techniques, ways of matching data and data lineage enhancements.

MiFID II/MIFIR II

The Markets in Financial Instruments Directive (MiFID II) constitutes the backbone for the upcoming financial market reforms. With the first proposal of MiFID drafted in October 2011, this regulatory framework has undergone over 2000 amendments. The current version of MiFID II still requires a great deal of attention from the regulators that need to re-address contentious issues revolving around the links between MiFID II and other regulatory frameworks such as EMIR and Dodd Frank. Although the costs of implementing MiFID II are not entirely clear due to legal and regulatory uncertainty, they are expected to be significant. However, 2015 will provide the firms with the opportunity to reduce MiFID II costs relating to post-trade optimisation and recognising synergies in reporting requirements for MiFID II and other regulations.

As noted in the high-level implementation timetable below (Figure 1), regulators and firms alike have a large change agenda ahead of themselves. Following the adoption of MiFID II, the industry is facing significant change between now and 3 January 2017 (the MiFID II date of application).

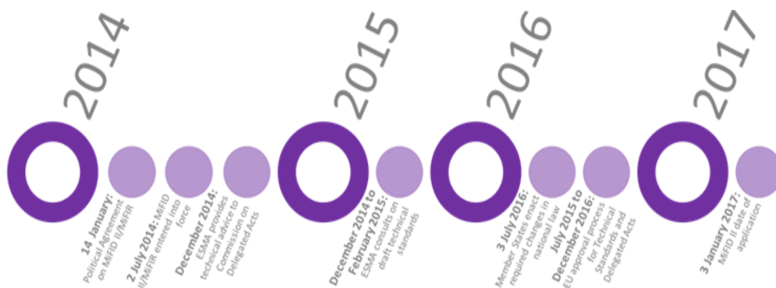

Figure 1: MiFID II Implementation Timetable

EMIR – Integrating Cleared and Un-cleared Derivatives

In a bid to increase transparency and mitigate systemic risk, regulators, through EMIR in Europe and the Dodd-Frank Act in the U.S, are forcing banks to clear standardised Over-The-Counter (OTC) contracts through central counterparties (CCPs). These changes will see an increasing number of vanilla and exotic trades cleared through CCPs in 2015. Any derivative contracts that are not centrally cleared will, under the new regulations, be subject to higher capital requirements than non-CCP cleared contracts. Clearing trades on a bilateral basis as opposed to using CCPs will mean that the capital requirements can rise by a factor of 50 times or more in certain instances.

Central to this is the need to invest in resources and develop solutions to integrate pre- and post-trade systems, as well as databases to comply with the increasing demands of regulators who require greater transparency, efficiency and stronger risk management practices in this space. With this in mind, 2015 will see a new level to which cleared and un-cleared derivatives are integrated, as well as the challenges being faced with their respective compliance initiatives.

Fundamental Review of the Trading Book

The Basel Committee published the third consultation [1] on the Fundamental Review of the Trading Book (FRTB) in December 2014 and started a 'final' Quantitative Impact Study (QIS) with the 31 December 2014 reporting date. Once the Committee has reviewed responses and results of the QIS, it intends to publish the final revised Accord text and implementation arrangements for the revised standards (including the timetable). Firms have until 20th February 2015 to respond to this latest consultation.

The overall increase in regulatory capital requirements for Trading Book assets will clearly reduce their profitability. The challenge for firms in 2015 is in identifying optimal structures and strategies to mitigate the impact of the reforms on implementation.

Capital Floors

Over the last 18 months we have observed growing scepticism by some regulators (not all) about the calibration of IRB Credit Risk models and the regulatory capital held as a result. Inconsistencies in approach and outcomes have been highlighted by various hypothetical portfolio exercises (although the industry has tried to explain why – and regulators have to an extent accepted that - such apparent inconsistencies result at least in part from inherent differences in banks' credit risk portfolio and capabilities). This has resulted in greater regulatory scrutiny of models themselves, a push to replace expert judgement with empirical evidence and in the FIRB style LGD floors imposed for low default portfolios.

At the end of 2015, the Basel Committee plans to establish a framework for capital floors based on standardised approaches. In December 2014, the Committee issued a consultative paper for practitioners' comments by March 2015. The new framework is to replace the current transitional floor, which is based on the Basel I standard - which in itself is not implemented consistently across all EU countries. The forthcoming regulatory changes ensure that the level of capital across the banking system does not fall below a certain level. Such an approach is believed to embark on setting a minimum average risk weight by risk category (e.g. credit risk, market risk and operational risk) that is calibrated to a percentage of the respective standardised approaches.

Recovery and Resolution Planning

European Parliament published the Bank Recovery Resolution Directive, (BRRD) on 15 May 2014, which empowers authorities to take direct action on financial institutions under resolution, and monitor minimum requirements for own funds and eligible liabilities.

The main preventative measure implemented by the Directive is to request recovery plans from financial institutions to be updated at least on an annual basis. The recovery plan requires the management to prepare for a crisis or event of financial instability – this process should ensure that appropriate measures are in place to be enacted in a timely manner. The Directive outlines four types of resolution tools that may be used in the event of a failing institution: from the sale of business to bail-in measures or transfer to a bridge bank and also introduces the concept of Minimum Requirements for Eligible Liabilities (MREL), which is compatible

[1] ***Fundamental review of the trading book: outstanding issues***

with the proposed FSB term sheet for Total Loss Absorbing Capacity (TLAC) for Globally Systemically Important Banks (G-SIBs).

Sovereign Debt issued by countries with high leverage might come back in focus in 2015 due to an increased global political instability and deflation pressures. This means that financial industry firms should be prepared to assess impact of Sovereign Debt deterioration on their portfolios in a timely manner and include this scenario in their recovery and resolution planning. Furthermore, the firms should be in a position to assess, at short notice, capital impact as well as direct and indirect exposures to a specific country as a result of its potential exit from EU and/or leaving the Euro zone. Ensuring that a firm's analytical and reporting capabilities are up to the task above is therefore one of the priorities for 2015.

Digital Transformation

The rise of smartphones, Big Data, artificial intelligence and the digitisation of all aspects of life are fundamentally changing the way that individuals and companies live their lives and interact with others. The first generation iPhone was introduced as recently as June 2007 but has proved to be a game changer across society. By 2018, there will be more than 10 billion mobile-ready devices and connections globally. It's clear that this digital age is upon us and that consumers are receptive to innovation in this area. Digitisation is changing the way consumers shop, the way they pay and how they interact with their friends, families, and of course the businesses they choose to buy from.

Digital propositions

Financial services firms are no exception to this technological revolution. Lloyds Banking Group (the UK's largest provider of digital banking products) is now opening around 3.5m products online each year and firms are investing heavily in their digital propositions. Innovations such as use of smart beacons, mobile payments and apps to streamline insurance claims are helping firms to differentiate and customise their customer propositions. Behind the scenes, firms are replacing costly and error prone manual processes with straight through processing, enabling them to accelerate delivery, reduce errors and slash operating costs. There has been a 38.5% reduction in UK bank branches between 2005 and 2012, we expect to see a similar or greater reduction in banks service centres as these efficiency gains bear fruit.

Risk Analytics

The falling cost of both computational power and data storage is revolutionising firms' analytical and predictive abilities. Financial firms have access to huge amounts of data about their customers, products and employees and are already developing new ways to mine and analyse this information to enhance to credit scoring, dynamically monitor customers' likelihood of default, detect insurance fraud, identify insider dealing, and to model conduct risk etc. Innovation in this area is expected to accelerate as firms find new ways to leverage their data and starts to combine their own proprietary data with external sources.

Cyber Security

With this innovation, IT resilience and cyber security are becoming critical concerns. The potential for online fraud is growing in line with the volume of digital transactions and firms need to be increasingly vigilant against new and creative scams. Additionally, new groups, for example "hacktivists", are now threating the security of firms' infrastructures. The growth of cryptocurrencies (e.g. BitCoin) is, in part, a reaction to concerns about the security of digital transactions, payment systems that avoid the need for participants to share confidential information (e.g. account details) will form an increasing part of the financial services infrastructure. We see an increasing focus on regulation of payments by EBA.

New Competitors

New technologies are bringing new competitors. Google (now has banking licenses), Apple (iOS now has massive payment capacity) and Facebook (holds e-money license) are all getting closer to entering markets historically being covered by retail/corporate banks. In addition, firms such as Amazon are manufacturing low cost tablets to enable them to control the portal consumers use to access online services – a significant competitive advantage when these start to actively promote digital banking services. While existing firms continue to be constrained by the antiquated design and resilience of legacy IT systems, we anticipate the IT powerhouses taking business from Institutions unable to modernise in time.

Business Optimisation

Immediately post crisis, firms' focus was simply to survive. As the industry and wider economy recover, firms are reviewing their strategies to optimise how they can best deliver shareholder returns in the new environment. Regulatory change and the increasing costs of capital have introduced new constraints and firms are seeking to exit non-core operations and reduce costs in their core businesses merely to stand still. It is likely that this will drive some consolidation amongst existing market participants as firms seek to build scale in their chosen core businesses and seek to acquire the assets and business units deemed to be non-core by competitors.

At the same time, new market participants are launching and new business models are challenging the models of the past. Sectors such as Peer to Peer (P2P) lending are growing exponentially and firms operating in this model are able to issue loans without holding debt on their balance sheets, they have a competitive advantage over traditional banks. Similar advantages exist for the new payments service providers and regulatory changes in the retirement market are likely to see insurers face significant falls in new business. If traditional firms are to remain relevant, they need to adapt their service offerings to meet changing customer needs, reduce costs and improve focus on their core business areas.

Finally, financial institutions are increasingly in the public eye and political and reputational risks are increasingly important to their profile and share-price. Increasingly, firms will need to move beyond "green wash" to actively monitor their social and environmental impact.

Some of the key challenges that we anticipate will demand firms' attention in 2015 are set out below.

Divesting Non-core Businesses

Banks are strengthening their balance sheets in order to pass stress testing exercises and asset quality reviews. Therefore, the increased capital requirements and more expensive pricing of risk, coupled with regulatory scrutiny will result in certain businesses being either banned or no longer attractive for banks. Banks are already in a process of a structural change that will involve divesting some non-core and less profitable businesses. Increased supply of 'unattractive' assets is likely to drive their price further down, potentially shifting balance from the sale of selected assets to the sale of entire business lines and even whole businesses thus fuelling M&A activity in financial industry in 2015. We will also expect to see some regulator (ECB) driven mergers between banks.

Collateral Optimisation

With regulations, such as EMIR and Dodd–Frank forcing financial institutions to clear more and more trades through Central Counterparties (CCPs) and post high quality collateral, the need for collateral optimisation has become more important than ever before. New regulations around collateral management are aimed at facilitating more effective risk management and enhancing trading relationships. However, these changes have vast operational implications for financial institutions that will need to deliver collateral in an efficient way while complying with the new rules and ever-increasing trade volumes.

Back Office Operations

Financial institutions have been focusing on improving the efficiency and performance of their revenue generating Front Office (FO) operations to increase profits and maximise return on investment (ROI) for a long time. However, changing market dynamics are forcing banks to recognise that it is very important to meet customers' expectations and provide quality services in order to remain profitable. In this pursuit, increasing the efficiency of their Back Office (BO) operations, which assist Front Office units, will become more important than ever before. Customers' expectations about the speed, accuracy and cost of executing transactions, firms that continue to rely on costly, slow and error prone manual processes will be at a significant disadvantage to more agile competitors.

Environmental Risk

2015 is likely to see Environmental risk to move up the agendas of financial industry firms. Investors' decisions are increasingly influenced by how well firms adhere to Corporate Social Responsibility (CSR) and Environmental Social Governance (ESG) policies in conducting their affairs. This means that the firms that understand their impact on society and environment and put in place adequate measures to be "green" can improve their reputation and increase their competitiveness through better access to capital, improved customer relationships, cost savings and increased innovation capacity. Last year Basel has started exploring its first inroads into 'environmental capital'. It is also important to note that European Commission encourages enterprises to "have in place a process to integrate social, environmental, ethical human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders." It might not be long before encouragement turns into regulation.

How can we help?

The ability of our clients to address the above issues means success to us. We are happy to help our clients in developing robust frameworks for risk management that CEOs and CROs can feel confident about. We believe that our risk management consultancy services will assist in decreasing operational costs, avoid regulatory penalties, address regulatory needs and gain competitive advantage in 2015.

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