FINANCIAL SERVICES OUTLOOK 2017

OVERVIEW OF KEY CHALLENGES FOR BANKS IN 2017
## Foreword

### Macroeconomic and political environment

### Prudential regulation

#### I. CRR 2: EU banking reform
- Market risk: FRTB finally lands in Europe, but more clarity to come
- Net stable funding ratio: The final piece of the liquidity regulation puzzle
- Interest rate risk in the banking book: More prescription comes with operational challenges
- Counterparty credit risk: The long awaited implementation and some more proposed revisions

#### II. Forthcoming Basel changes
- Operational risk: Finding the right regulatory capital response to this increasingly broad and prominent risk type
- Standardised approach to credit risk: Greater risk sensitivity at the cost of operational complexity
- Standardised floors: A significant and highly contentious new capital constraint

#### III. Reporting requirements
- SSM regulatory reporting developments
- IFRS 9: The end of the road

#### IV. Supervision
- ECB SREP: A sharp focus on business models and risk management
- Model management: The ongoing, ambitious and highly significant TRIM project
- Stress testing: Getting value from these increasingly tough prudential tests

#### V. Structural reform and resolvability
- Capital and loss absorbing capacity: The role of TLAC in holistic capital management
- The Single Resolution Board: Ramping up

## Conduct and compliance

#### I. Conduct risk: The evolving regulatory approach

#### II. The 4th Anti-Money Laundering Directive and the fast changing environment

## Technology

#### I. Fintech: The prophecy is coming true

#### II. Supervisory use of technology
RISK MANAGERS WITHIN BANKS WOULD BE FORGIVEN FOR ENTERING 2017 WITH A SENSE OF TREPIDATION. ENOUGH HAS ALREADY BEEN SAID ABOUT THE UNEXPECTED EVENTS OF 2016 AND THE POTENTIAL FOR FURTHER SEISMIC RISK EVENTS TO OCCUR THIS YEAR IN THE POLITICAL AND ECONOMIC WORLD. BUT, WHILE WE HAVE BEEN StarkLY REMINDED THAT UNEXPECTED THINGS DO INDEED HAPPEN AND THE IMPLICATIONS ON RISK MANAGEMENT, THERE IS A LOT THAT WE DO KNOW, AND A LOT WE CAN PLAN FOR.

IN THE CHINESE LUNISOLAR CALENDAR IT IS NOW THE YEAR OF THE ROOSTER, WHICH BRINGS TO MIND IMAGERY OF A NEW DAWN AND A FRESH START—A CHANCE TO TAKE STOCK OF WHERE WE ARE WITH CURRENT CHALLENGES, THE KNOWN NEW CHALLENGES AHEAD AND FURTHER CONTINGENCY PLANNING FOR THOSE UNKNOWNS. WE HOPE THIS PUBLICATION AIDS THAT PROCESS.

HERE, WE PRESENT A SUMMARY OF WHAT WE SEE COMING IN THE WORLD OF RISK, REGULATION AND RELATED TECHNOLOGICAL DEVELOPMENT, AGAINST THE POLITICAL AND ECONOMIC BACK-DROP, AND WHERE WE EXPECT LEADING INSTITUTIONS TO FOCUS THEIR EFFORTS. THIS IS BY NO MEANS AN EXHAUSTIVE EXPOSITION OF ALL OF THE MAJOR RISKS FACED BY BANKS TODAY. FOR EXAMPLE, SOME OF THE TOP RISKS IDENTIFIED BY BANKS FOR THIS YEAR ARE IN THE OPERATIONAL RISK SPACE, INCLUDING CYBER THREATS, OUTSOURCING AND OF COURSE, MANIFESTATIONS OF GEOPOLITICAL RISK. OUR FOCUS HERE IS MAINLY ON REGULATION AND ASSOCIATED CHANGES IN THE RISK ENVIRONMENT.

PRUDENTIAL REGULATION HAS CHANGED CONSTANTLY SINCE THE CRISIS AND THIS CONTINUES INTO 2017. BUT WE ARE NEARING THE END, AND HOPEFULLY THIS COULD BE THE YEAR WHEN NEW REQUIREMENTS SETTLE DOWN AND REAL STRATEGIC INFRASTRUCTURE CHANGE CAN ACCELERATE. OUR PRUDENTIAL REGULATION SECTION COVERS THE WELCOME CLARITY PROVIDED BY THE ‘CRR 2’ PROPOSALS LATE LAST YEAR AND OUR VIEWS ON THE HOTLY DEBATED REMAINING ELEMENTS OF BASEL III.

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We also highlight the impact of TLAC on capital management and the implications on banks within the Single Supervisory Mechanism of the intensive work on resolvability by the Single Resolution Board.

Supervisory approaches continue to evolve, keeping pace with environmental and technological change. We explore how European regulators are fine-tuning their approach to SREP, stress testing and model management and what banks should anticipate in order to meet expectations.

Regulatory reporting and disclosure has been a particularly demanding feature of the supervisory world in which we now live. Changes continue to abound, but similar to the underlying prudential rules, there is a sense of pragmatism and proportionality coming. While there are new requirements to get ready for, such as AnaCredit, and long-running challenges such as IFRS 9 that are coming to a head, banks’ priorities can start to shift to strategic reporting solutions which include enhanced analytics, enabling senior management to extract value from these new requirements.

Outside the world of financial regulation, we see an ever increasing interest by regulators in conduct risk. Conduct risk is, by definition, not a passing trend that will subside when something bigger comes along. Its nature is a function of what is going on in the world around us. As banks’ business models evolve because of economic and political factors, and as their processes are enhanced by technology and data, their conduct risk profile changes. Conduct risk is only going in one direction: it is a more significant risk class than ever; and regulators are acutely attuned to this. In the UK, the FCA has a prominent voice in this regard and they have sign-posted a number of focus areas in their consultative ‘mission’ that we summarise in the conduct and compliance section. We also highlight anti-money laundering, an important area of regulatory compliance in the world of financial crime that will consume significant resources this year.

What is fascinating is that while all this regulatory upheaval has unfolded, a technological revolution has been happening in parallel. New entrants in the fintech and regtech space are transforming the industry landscape, incumbents are becoming much more innovative and investing in new ways of engaging with customers and undertaking business processes, and technologies supporting machine learning and cognitive processing are set to quickly move beyond proof-of-concept. Our technology section explores the fast-changing and seemingly unstoppable trends we expect to continue in 2017.

We hope our summary and perspectives are useful as the year gets underway and as plans develop to tackle the vast array of changes ahead, and to be in a strong position to react to the changes that we don’t yet know about.
A former British Prime Minister was once asked what worried him most. “Events, dear boy, events” was his simple answer. 2016 was a year of political upsets, with both the UK Brexit referendum and the US Presidential election delivering results contrary to the ex-ante polling, a telling lesson in the importance of sampling error when seeking to measure a future unknown event. The key lesson for risk managers is this: the unexpected happens. Opinion polls carry a margin of uncertainty, which in the presence of a borderline decision should never be overlooked. Risk managers are not however political or economic forecasters; our job is to consider a range of outcomes, and assess these individually, before determining if mitigating actions are required.

Whereas the 2016 Brexit vote had the relative simplicity of being a binary decision (Remain/Leave), the resulting negotiations – due to start in the first half of 2017 – lack brevity for possible outcomes. Instead of a binary result, one has a spectrum of outcomes, ranging at one extreme to a “Soft Brexit”, under which there is limited disruption to future UK-EU relations, via “Hard Brexit”, with substantial changes to relations, to “No Deal”: the hardest of possible Brexit outcomes. All financial services companies (within the UK and in the rest of the European Union) will require contingency plans to enable responses to different flavours of Brexit, to deal with non-trivial issues Passporting of Licences, and the Settlement and Clearing of euro denominated trading. Also, as with any strategic and operational reorganisation, talent management and retention is an issue not to be underestimated. This should rank amongst the top concerns with any Brexit contingency plan. Under all but the most favourable of exit terms, multinational institutions will need to re-evaluate their business models. A prudent risk manager will evaluate the possible outcomes and make contingency plans to move selected operations to the eurozone.

The Brexit discussions will take place against a backdrop of domestic elections, with the Dutch parliamentary election in March, French presidential elections in April and May, and German federal elections in the autumn. Each of these elections becomes a test of public faith in established institutions, versus the growing appeal of populist rivals. Expect increased market volatility in the immediate run-up to these elections, as market participants increasingly apply their own haircuts to polling forecasts and seek to manage their own position.

Stepping back from domestic political considerations and looking at the broader economic canvas, we see increasingly lacklustre economic performances in many European countries. This invariably has a long-term impact on the credit cycle and NPL volumes, as we are already seeing with concerns about a number of Italian banks. Whilst the economic outlook continues to be harsh, with risks mainly to the downside, meaningful changes in monetary policy seem unlikely.

Eurozone interest rates remained negative throughout 2016, and are expected to remain negative for the foreseeable future. This places downward pressure on net interest income margins, and thus places increasing pressure on the profitability of a bank. Restoring income to sustainable levels requires a re-evaluation of the business model, with an increased need to replace interest income with fee income, combined with efficiency savings through headcount reduction and digitisation. Supervisors fear that many banks will seek to restore earnings through increased risk taking (“search for yield”), a process which invariably exposes participants to potential future reversals of risk premia in troubled markets, such as those associated with real estate and commodity production.

It is sometimes said that the definition of an Emerging Market is one where the politics matter more economics. Applying that definition strictly might lead one to conclude that the West has become an Emerging Market. Even if this is an over-reaction, it underlines the prevailing uncertainty which investors face as they attempt to navigate 2017, and the complexities which risk managers will need to manage.
Could this be the year that the ground stops shifting in the world of prudential regulation? Since the financial crisis, reform of prudential regulation for banks has resulted in rule changes—year in, year out. Basel III, and the resulting changes to the CRD in Europe represented the biggest driver of change in the financial strength of the sector. Structural reform, and recovery and resolution planning, are adding to this resilience with measures affecting the structure of banks’ operations and their crisis management and contingency plans.

There are still a couple years in the existing Basel transition period. The Basel Committee is close to finalising the remaining elements of Basel III, popularly referred to as Basel IV. Furthermore legal entity changes are afoot: in the UK, banks will have to implement their ring-fencing plans, the timing of which coincides with the planned departure from the EU and any structural change that this might necessitate.

So, this could be the last year of rule changes for European banks. But, that is far from certain, and there is still a lot of implementation which remains to be done. The debate on the remaining prudential standards being in Basel has not yet reached international consensus so has not yet been agreed. This means that items like capital floors and operational risk are still out there as potential issues that create further binding constraints on capital resources and balance sheets. Also, Brexit casts uncertainty around the future alignment of UK regulation to European rules. And there is clear potential for further divergence with the US, which affects many global banks.

While all this change is still taking place, banks have not had the luxury of waiting to assess the impact on their infrastructure and business models. They have been trying to keep pace, but could turn a corner this year if all the variables become known. The optimisation problem created by the proliferation in capital, leverage and liquidity rules can at least be finally defined, even if it is a scarly complex one. And the infrastructure investment needed desperately can be made with the knowledge that the rules of the game have reached a relatively steady state.

In this section, we explore the impact of the ‘CRR 2’ proposals on banks, the likely impact of the remaining Basel changes, the ever-increasing demands on reporting and disclosure, the supervisory priorities and approaches signposted by regulators, and the next phase of resolution planning.

I. CRR 2: EU BANKING REFORM

Banks have been familiar with the elements of the proposed CRR 2 reforms for some time now. Many have started implementation on areas such as market risk (through the fundamental review of the trading book), counterparty credit risk (with the new complexities added to the standardised approach), and have enhanced some of their balance sheet management approaches by considering changes to requirements on interest rate risk in the banking book ('IRRBB') and the net stable funding ratio ('NSFR').

So, it was a relief to get some certainty in the rules through the 23 November publication of the European Commission’s proposals. But now the implementation efforts must ramp up in earnest. The devil, as always, will be in the detail so there is no substitute for a granular impact assessment and gap analysis to identify policy, systems, processes and data requirements for implementing these reforms.
Market risk: FRTB finally lands in Europe, but more clarity to come

FRTB has been creeping along for some time now, in terms of the extent of clarity on the rules, the approach planned by national regulators and, as a consequence, the implementation efforts by most banks. Now that we are close to having CRR rules on these new market risk capital requirements, banks can accelerate implementation efforts with more confidence. We don't yet have perfect clarity on crucial elements such as the model approval process, but there is now a steadier platform upon which banks can make key implementation decisions.

As a bit of history, in January 2016, the Basel Committee published the revised standards for minimum capital requirements for market risk (dubbed the fundamental review of the trading book). The new standards are an important step within the post-financial crisis review of the prudential framework and address what the Committee identified as structural flaws in the existing framework. The new standards therefore represent a significant change, incorporating:

• A review of the banking book/trading book boundary (the boundary is more prescriptive and constrains reassignment of positions between the banking and trading book);
• A review of the standardised approach (which is more risk sensitive); and
• A review of the internal model approach (new rules defining what internal models must measure and how their appropriateness is ensured).

The industry has raised many questions concerning the interpretation of the standards with the Committee. Furthermore, some industry participants are still hoping for some changes to the standards, in particular the rules that govern when internal models are considered appropriate (supported by the P&L attribution test). The Basel Committee has recently issued an FAQ document on this topic – something many see as a welcome start to industry dialogue.

In the November 2016 European Commission proposals for the revision of the CRR, the Basel text is largely transposed into the draft standards. Under the proposal the EBA would be mandated to issue Regulatory Technical Standards (RTS) addressing many of the topics raised by the industry. However, the proposal contains few notable differences from the standards issued by the Basel Committee:

• The existing standardised approach (which is primarily based on the notional of positions) would be maintained for banks with a small trading book;
• Concerning the revised standardised approach:
  - The risk weights for covered bonds are lower therefore generating lower capital requirements for these positions; and
  - The formula for the standardised default risk charge has been amended; and
• Concerning the revised internal model approach, some rules have been amended which could have significant impacts on the total capital requirements, in particular wording of P&L attribution and non-modellable risk factors.

Also in November 2016, the EBA published final standards on assessment methodology to validate market risk models, which is a RTS that complements the existing CRR concerning the permission to use internal models. The EBA explicitly references the new Basel standards mentioning that some elements are already reflected in the RTS. The RTS contains rules that are relevant only under the current regime (e.g. assessment of significance of positions included in the scope of market risk internal models). However it also contains many qualitative requirements that are likely to remain relevant even after the CRR revision (e.g. requirements around risk appetite).

It is expected that in 2017 banks will expend more effort in the analysis of the new standards to ensure they make appropriate methodology and policy decisions as well as plans for upgrades and changes to systems and operating models.
This will include the usual challenges around data, processes and IT infrastructure. There are many decisions needed in this respect, including whether to expand the existing market risk and pricing infrastructure or to replace it with something new. Many banks will use this regulatory change as an opportunity to enhance their market risk analytical capability through improvements to processing speed, analysis of data and more dynamic and granular reporting modules.

On top of this additional compliance effort, the Basel standards are expected to increase capital requirements when they enter into force — the EBA standards are not expected to have a significant impact in terms of capital requirements —, which, according to the Basel standards, should be by the end of 2019. By the Committee’s own estimates the capital requirements will increase capital requirements for market risk by a median 22% (40% using a weighted average) with the increase mostly due to higher capital requirements for the standardised approach. The estimations of the Committee provide wide differences with the capital requirement for market risk for the 25th percentile down by 28% while the requirements for the 75th percentile double. Therefore banks should be cautious in drawing conclusions from these and undertake their own analysis.

Net stable funding ratio: The final piece of the liquidity regulation puzzle

Also as part of CRR 2, the European Commission proposed to make the NSFR a binding requirement. In many respects, the European Commission followed recommendations made by the EBA last year to implement the Basel standards with certain adjustments to reflect European specificities. This fine-tuning is intended to avoid disproportionate impacts on certain activities, such as covered bonds issuance or trade finance, and to promote the liquidity of securities markets.

The introduction of the NSFR completes the Basel III agenda on liquidity in the EU, along with the Liquidity Coverage Ratio and the associated reporting of Additional Monitoring Metrics. While banks have been gearing up for the implementation of the NSFR standard for quite some time, further efforts are needed to operationally integrate NSFR reporting and analysis into balance sheet management and contingency planning.

Interest rate risk in the banking book: More prescription comes with operational challenges

The CRR 2 proposals draw on the standards for IRRBB finalised by the Basel Committee in April 2016, which updated the regulatory framework for this increasingly important component of balance sheet and capital management.

Here are the salient points:

- It introduces a reference to credit spread risk in the banking book;
- The outlier test becomes more constraining due to a reduced threshold, a narrower definition of capital and a substantially more complex set of interest rate shocks. Failing the test not only leads to heightened supervisory scrutiny (“comply or explain”) but informs supervisory capital requirements under pillar 2;
- The proposed framework paves the way for a standardised methodology to measure IRRBB exposure, as a fall-back solution where supervisors consider banks’ own Internal Measurement System to be inadequate; and
- Detailed disclosure requirements are introduced aligned to regulator prescribed interest rate scenarios.

Stress testing requirements represent one of the major operational and methodological challenges posed by these rules. Banks are becoming more sophisticated when it comes to
stress testing of the banking book, but these new rules will pose yet more challenges to the availability of data in running the bank-specific and regulator prescribed scenarios. Solutions will need to be found to deal with the fact that there simply might not be a wealth of historical data to support assumptions about customer behaviour for some product classes in certain interest rate shock scenarios.

Overall, the proposals put forward by the European Commission update and strengthen the prudential framework for IRRBB. In a context of economic and political uncertainty and accommodative monetary policy in Europe, this risk should remain material over the medium term and therefore a priority for bank supervisors. Pending the legislative process, the EBA is mandated to develop technical standards to further specify the regulatory framework and may update its own IRRBB guidelines to incorporate the more qualitative elements of the new Basel standards.

Counterparty credit risk: The long awaited implementation and some more proposed revisions

The Standardised Approach to Counterparty Credit Risk (SA-CCR) requires banks to address challenges in systems integration, trade booking alignment, model infrastructure, reporting and underlying process. In the CRR revisions proposed in November 2016, new rules on a simplified SA-CCR were introduced. In order to ensure proportionality, the eligibility criteria on the Original Exposure Method (OEM) was modified, with the introduction of a simplified SA-CCR. The Basel committee first published the new standardised method to calculate exposure for OTC derivatives in March 2014. This was to address the shortcomings of the existing methods, namely the Current Exposure Method (CEM) and the standardised approach (SA). In fact, as part of the Basel agenda, CEM and SA are replaced by SA-CCR, which is designed to be more risk sensitive. The Basel rules will also impose the use of SA-CCR for calculating exposure and then feeding this into large exposures reporting. This will be the case even for firms with internal model approval, so it will be important to have appropriate and robust infrastructure in place from data acquisition through to reporting.

Overall, SA-CCR will focus banks’ attention this year on enhancing their large exposures reporting and improve underlying processes for the monitoring of credit exposures. Getting product taxonomy right across interest rate, FX, credit, equity and commodity derivatives will be very important in order to ensure correct exposure treatment under SA-CCR rules.

Intermediate EU holding companies for large non-EU banking groups

A surprise late addition to the legislative proposals will require large non-EU banking groups to establish an intermediate holding company subject to EU capital, leverage, liquidity and other prudential rules on a consolidated basis. This will have a particularly large impact on overseas banking groups that have significant amounts of their European operations through branches, causing banks to have to think about location of capital and funding flows as well as operational, people and governance aspects. The interplay between this and firms’ Brexit-driven location and structure decisions will be interesting.

II. FORTHCOMING BASEL CHANGES

The Governors and Heads of Supervision (GHOS) said in early January, that more time is needed to finalise some work on the last remaining components of Basel III. The oft-used expression ‘nothing is agreed until everything is agreed’ certainly holds true for the Basel Committee. The items still to be agreed include the new operational risk framework, the standardised approach to credit risk capital requirements and the imposition of capital floors. These are not trivial changes. For many banks they will impose higher capital
requirements, challenging capital optimisation problems, and implementation issues surrounding data and processes.

In preparing for future changes, it is important that banks take part in QIS exercises to help calibrate the standardised capital framework and perform their own internal impact analysis. Changes to balance sheet composition should be considered carefully, along with impact on pricing. It is important that cliff-edge effects are avoided or mitigated so that stability in pricing and capital are achieved.

But the challenge this year won’t just be a matter of beginning to implement what finally get agreed. The challenge will also come from the distinct possibility that a global consensus cannot be reached, creating geographical disparity, raising questions about how to structure global business models.

Pre-deal and optimisation analysis: Greater sophistication and efficiency

Basel III first changed the quantum and quality of capital, the extent of balance sheet leverage, and the minimum liquid assets they need to hold. The latest round of rules significantly change the calculations determining capital requirements in the denominator of the ratio, and threaten to significantly curtail the impact of modelled outcomes in this respect. The optimisation problem gets harder in terms of overall balance sheet strategy, but also in pre-deal assessments and what-if analyses.

Banks should adopt a comprehensive approach to the calculation of risk sensitivities that satisfies multiple regulatory requirements at once – one that enables fast computation for pricing and hedging purposes. For example, the approach should be consistent for SA-CCR, the SBA approach in FRTB and the ISDA Standardised Initial Margin Model (SIMM). Graphical Processing Units (GPUs) and Adjoint Algorithmic Differentiation (AAD) are approaches that could be employed by trading desks and risk functions to significantly speed up calculations and move banks closer to real time pre-deal assessment.

- GPUs are essentially computer cores that can process multiple instructions in parallel, generating speeds up to 100 times faster than traditional Central Processing Units (CPUs).
- AAD is a mathematical technique that enables simultaneous, rather than sequential calculation of a host of risk sensitivities, generating speeds up to 1000 times faster than traditional CPUs.

Those banks that can price their deals faster using GPUs and AAD, accounting for credit, funding, initial margin and capital costs through the life of a transaction, will have a competitive advantage over their peers.

Operational risk: Finding the right regulatory capital response to this increasingly broad and prominent risk type

Capital requirements for operational risk used to be the least talked about element of the prudential regime for banks. This past year, that has changed as regulators are looking to overhaul what is seen as a system characterised by either insufficient risk sensitivity (in the standardised approaches) or unacceptable model risk (in the less frequently used advanced approach). This feels like an appropriate area to focus on
because, capital calculations aside, banks are more focused on operational risk than ever before because the risk is greater and systems from more sources than ever before. Consumer protection, financial crime, cyber-security, data protection represent just a few significant sources of operational risk that are all high atop banks’ and their boards’ agendas this year.

The shelving of the Advanced Measurement Approach (AMA) for operational risk represented one of the biggest regulatory volte-faces in living memory. The realisation that the complexity of AMA and the lack of comparability of different bank models and their outputs was one that many practitioners would agree with. However, the proposed replacement has itself not been without controversy. Our expectation is that developments in the replacement for AMA and the Basel approaches to operational risk will be a key outcome in the prudential agenda for 2017.

A number of institutions, having invested a great deal into onerous, complex and time-consuming (read: expensive) change programmes were understandably upset by the degree of effort expended. That said, a number of the outputs of these programmes will continue to be used. Particularly irritating for these banks is the lack of regulatory capital benefit from significant tracts of the work performed.

While the Standardised Measurement Approach (SMA), proposed last year, will provide some comfort to those who had not invested significant resources into the AMA, as well as providing clarity to the marketplace after years of debate, this change of tack has raised criticism from both fans and critics of the AMA.
Concerns exist about the degree to which investment in operational risk scenario analysis and modelling will continue with reduced regulatory impetus and the consequent potential weakening of operational risk management at some banks. Whilst there is no intention to increase overall operational risk regulatory capital, there will be winners and losers from the new regime. The revised scaling of operational risk capital charges disproportionately affects larger banks with high operational risk losses. A number of cliff effects, such as all loss events in the last 10 years being counted equally, or large jumps in regulatory capital requirements occurring at loss thresholds have also been identified.

It is clear that the lack of sensitivity of capital allocated to operational risk by banks during the global financial crisis and the myriad of operational risk losses that occurred in the following years, often without significant increases in operational risk capital requirements, demonstrated that the original system was not suitably reactive to developments in the operational risk environment.

However, considering the aim of improving comparability, the use of financial information (Business Indicators) and idiosyncratic internal loss experience will doubtless remove a lot of subjectivity from the numbers produced, especially when compared to the AMA. But comparability won’t be perfect under the current proposals, which have been criticised by some industry participants, who worry that there is no ‘standardised’ way to categorise operating loss data in terms of levels of aggregation of multiple but related events, and allocation to time periods and businesses.

At present, after the third and most recent consultative Basel Committee document, we await further refinements.

There is a regulatory push to reduce the mechanistic reliance on external ratings, using banks; own due diligence and risk management to drive risk weights and capital requirements. Significant revisions are proposed to the treatment of different exposure classes, such as multilateral development banks, banks, corporates, and real estate (acquisition, development and construction of commercial and residential real estate). The objective is to ensure that the Standardised Approach acts as a credible, comprehensive and sufficiently risk sensitive alternative to the Internal Ratings Based (IRB) approach. The proposals create significant capital and operational impacts and challenges for banks.
Changes to balance sheet composition should be considered, based on an understanding of the drivers of credit risk capital requirements such as creditworthiness, exposure size, concentration, and risk mitigation with collateral and guarantees.

Banks need to consider the impact of the rules on their underlying systems and processes including not only the calculation of capital requirements but, further upstream, in credit workflows. With the need to perform due diligence on ratings and evidence changes across the lifecycle, there should be a focus on ensuring systems are capable of complete, accurate and timely reporting. Policies and procedures will need to reflect the enhanced due diligence requirements and be able to withstand regulatory scrutiny. Failure to do so will likely lead to increased risk weights and therefore higher capital requirements.

Deal assessment and pricing will need to be considered in light of new requirements. Pre-deal analysis tools will need to be adapted or developed to assist the understanding the trade-off between revenue generated and capital consumption to help guide optimal pricing decisions.

Banks also need to consider how they report their credit exposures and capital for the purposes of pillar 3 disclosures. Having the right infrastructure that enables granular reporting and flexibility is important, as there is a move towards inclusion of hypothetical RWA, with the standardised approach to credit risk acting as a credible and comprehensive alternative to the approach.

Standardised floors: A significant and highly contentious new capital constraint

As regulators strive to enhance the capital regime across credit, counterparty, market and operational risk while balancing simplicity and risk sensitivity, and by improving comparability through reducing RWA variation across banks and jurisdictions, revised standardised capital calculations have come to the fore. Additionally, regulators are considering restricting or removing the use of internal models with respect to A-IRB (for certain portfolios), IMA CVA (so only SA-CVA and BA-CVA will remain) and, as discussed earlier, AMA for operational risk.

Alongside these measures, discussions are ongoing about employing some version of standardised capital requirements as floors to the internally modelled calculations. This topic remains one of the most contentiously debated topics in Basel, with lobbying efforts by national regulators, firms and their trade associations. To replace the Basel I floor, the options being considered are an aggregate floor (between 60% and 90%) or more granular floors, aligned to the different components of risk capital. There is also consideration of a floor on the internal model method for counterparty credit risk (IMM-CCR) based on a percentage of the applicable standardised approach.

As the various elements of Basel III have been introduced and phased in, balance sheet optimisation has become harder as more variables and constraints are introduced. Capital floors represent an additional major variable to this complex problem. As this contentious set of rules hopefully lands this year, banks will have to update the analysis of their business models, product and exposure mix and capital allocation to take account of any changes or unexpected areas where these floors may ‘bite’.
III. REPORTING REQUIREMENTS

Piling on new regulatory reporting requirements has been one of the key ways in which regulators have enhanced their supervisory approaches. Banks have been keeping up — at least with tactical solutions — while gradually implementing more strategic approaches to data sourcing, aggregation, analytics and report production.

This year, the changes to pillar 3 disclosures will be finalised and implemented by most large banks, after the EBA published their final guidance late last year. This does not change the existing disclosure requirements enshrined in CRR, but is aimed at implementing the revised pillar 3 regime published by BCBS in January 2016, ensuring consistent application across the EU through prescribed presentational formats (for use in 2017 for the largest institutions).

These developments are encouraging insofar as the finalisation of reporting rules enables systems and process change to be undertaken with more confidence. In the SSM, efforts are being made to devise a coherent reporting framework. This is explored below, along with the various recent developments that banks in the SSM will have to focus on this year.

SSM regulatory reporting developments: Harmonisation and data quality in focus

Availability of sufficiently granular and reliable data is a major priority of the Single Supervisory Mechanism (SSM). To this end, the ECB has continued to demand additional and more granular reporting from banks under its supervision. Along the way, banks can expect to dedicate significant effort in 2017 to address new harmonised and local reporting, increasing pressure on data quality, and a new reporting framework.

New harmonised and local reporting

Along with the evolution of harmonised reporting and other stable reporting streams (such as the Short Term Exercise), in 2017 banks can expect new reporting initiatives while in parallel working on new reporting requirements that will start in 2018. Banks will also need to apply further focus on NPLs in completing the “ECB Non-Performing Assets Strategy Template”.

In fact, the ECB has launched a new data collection mechanism for NPL portfolios with the goal of capturing detailed information on exposures (PE and NPL), guarantees, forbearance measures and any recovery procedures.

Essentially replicating the NPL Stock Take request from last year, this new template will be introduced with the aim of providing prospective information to supervisors concerning economic and macro-economic phenomena within banks.

The content of the new template, the due date for which is still under discussion, provides different types of classification based on FINREP portfolios, the detail of the accounting data on the NPL for the calculation of the Monitoring Indicators, and rich information on guarantees. The report will also contain detailed information about past-due positions.

Representing a major change from the previous exercise, this new template will require information on a five-year horizon from 2017 to 2021.

In parallel to the 2017 reporting, banks must invest significant resources to address new requirements which are required from 2018 and onwards, among these are:

• The Analytical Credit Dataset (AnaCredit) is based on granular credit data within the context of a harmonised supervision
approach. Its implementation is a key challenge for banks that needs to be addressed in a short timeframe;  
• IFRS 9, under which banks need to be able to report in 2018, with transitional Own Funds requirements as part of CRR 2; and  
• Revised SA-CCR, leverage and large exposure reporting expected in 2018.

Lastly, banks should be prepared to allocate significant resources to supplemental reporting requests at the national level from NCAs.

Data Quality
In 2017 data quality, and more broadly data management, will require special focus. In particular, the data quality implications of BCBS 239 will play an important role in the new monitoring process that the ECB intends to launch. The importance of data flows produced and manipulated for supervision and benchmarking will grow further with the Data Quality Escalation Process through which the ECB will start to monitor the trend and the quality of the reporting flows in 2017. The Data Quality Escalation Process will observe closely the quality of data produced by the supervised entity, specifically through KPIs, such as the timing of sending and related delays, but especially the number and severity of errors in the reports, and the necessary time to correct these errors.

Reporting framework
This year will see a system of harmonised primary reporting in the eurozone going into effect, which includes ECB/EBA regulations and guidelines. The framework is based on XBRL and the Data Point Model, which are already familiar to banks. The impact of this new approach is expected to be different from country to country. The DPM is representation of a data structure describing business concepts (relevant for the supervisor) with their definition, properties and the relationship between them. The (accompanying) XBRL taxonomy translates the data into a technical language (readable by computers) for submission.

The role of banks Integrated Reporting Dictionary (‘BIRD’) will be developed along with the integration with tools and procedures administered by NCAs to support the data production process (e.g. Puma2 for Italy). In the first quarter of 2017, the BIRD pilot will be concluded and it will cover not only AnaCredit but also Statistics on Holdings of Securities (‘SHS’).

IFRS 9: The end of the road
Nearly four years ago, many firms initiated work to implement the new accounting standard IFRS 9 replacing decades of IAS 39 legacy. This has proven to be a monumental task for many institutions where there has been an urgent need for system changes and model and plenty of judgements around this significant accounting policy change. From 1 January 2018, firms will need to implement the new standard to support their 2018 statutory financial reporting.

While many firms have already made significant progress in updating their systems, internal controls, existing models and financial reporting systems, many firms are lagging behind and there is now significant pressure to deliver. The to-do-list is still significant and will require urgent management attention. Among the priority implementation items for many firms are the following:

• Data sourcing: Availability of historical data to support the forward expected credit loss model is a challenge;  
• Model development: New models and supporting processes are needed or the adaptation of existing Basel models;
Prudential regulation

- Testing: Parallel runs will be necessary to identify significant deviations and unexpected results; and
- Capital planning: Assessing the impact on regulatory capital, and building this into business plans, capital plans and stress testing.

**Model development**
IFRS 9 has represented one of the biggest challenges for credit model development teams; adding to the volume of extra demands on model development and model risk teams following the 2008 financial crisis. Some of the topical modelling focus points relating to IFRS 9 continuing into this final year of preparation include:

- Definition and inclusion of drivers of customer behaviour in the medium to longer term;
- Difficulties estimating long term marginal default rates; and
- New validation techniques must be developed including back testing of model outcomes to ensure overall provisions are appropriate in addition to the regulatory required focus on individual parameters. Also validation must identify errors caused by incorrect macro-economic predictions which must be clearly separated from the normal default rates predictions.

**Impact on regulatory capital**
In October 2016, the Basel Committee issued a consultation paper (which is now closed) where several transitional scenarios were identified:

- Banks compare their CET1 under the new standard and spread the hit over a three year period;
- CET1 capital adjustments linked to day 1 proportionate increase in provisions; and
- Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions.
The European Commission has proposed (via Article 473a of the draft CRR 2) to phase in the new credit provisioning requirements into own funds calculations over the period starting 1 January 2019 and ending 31 December 2023, in order to mitigate the financial impact on institutions. This is a very welcome move, as it will avert a sudden drop in regulatory capital. It is estimated that the increase in provisions as a result of IFRS 9 will reduce the CET 1 ratio by 200-300bps.

**Stress testing**

Banks’ stress testing approaches and processes must adapt to account for IFRS 9 implementation. The UK regulator has made it clear that banks will be required to estimate IFRS 9 provisions in the prescribed stress scenarios. The same will apply in the 2018 EBA stress tests.

Apart from the impact on stressed capital ratios, banks have to look at some methodological challenges for model development. Some banks are still struggling with the complexities around IFRS 9 loan loss modelling. IFRS 9 credit loss methodologies into the construct of a multi-year stress test will exacerbate this challenge.

**IV. SUPERVISION**

**ECB SREP: A sharp focus on business models and risk management**

In the wake of the completion of the second SREP exercise, banks are already looking forward to 2017’s main regulatory challenges. In mid-December 2016, the ECB published the SSM supervisory priorities for 2017. Based on the assessment of the key risks faced by banks and taking into account the current regulatory and economic landscape, three priorities have been identified.

The first one is on business models and profitability drivers. The ECB will perform in-depth examinations in 2017, including a dedicated thematic review, which will include an assessment of the medium and long-term impacts of low negative interest rates, and the anticipated effects of Brexit.

The second priority is credit risk, with a particular focus on NPLs and portfolio concentrations, which continue to be of concern, especially in the light of IFRS 9 implementation.

The third focus area is risk management, which covers a wide range of topics already assessed and some new ones identified as necessary to assess. Risk governance, capital adequacy (ICAAP and Stress tests) and liquidity (ILAAP) will remain areas of heightened attention. Additionally, compliance with BCBS 239, the targeted review of internal models (TRIM – explored further below) and outsourcing risk are added to the areas of focus for 2017.

The ECB confirms its current approach by pushing banks to implement and maintain strategic processes and governance frameworks embedded in business models and strategic plans. Moreover, the ECB is showing it is willing to be more intrusive in its supervisory approach.

**Model management: The ongoing, ambitious and highly significant TRIM project**

In 2011, the Federal Reserve issued its increasingly cited paper SR11-7, Guidance on Model Risk Management. This paper makes the fundamental point that model risk is a risk like any other, and should therefore be managed accordingly.
Adaptation of this philosophy requires a step-change in the thinking of many banks, where model governance has hitherto been focussed on the operational process of model development, implementation, validation and approval. Taking a risk sensitive approach to model risk starts with the recognition that any request to approve a model is a request for a marginal increase in total model risk, and must therefore be justified in terms of benefits. It therefore becomes incumbent on the model owner to demonstrate that the benefits of the model justify the incremental risk. Furthermore, by treating model risk as a risk type like any other, it invariably becomes part of the pillar 2 regime, with its own capital requirement. Within such a setup, complex models make limited sense where the underlying business has limited profitability.

More recently, the ECB has launched perhaps its most ambitious project to date: a Targeted Review of Internal Models (TRIM). This project aims to review all Internal Models used by ECB supervised banks – approximately 13,000 models – and issue, where appropriate, instructions for the improvements of individual models. The long-term consequence of the TRIM project will be the emergence of a new range of technical standards appropriate to credit and market risk models: in short, a better class of model. Adaptation of these improved standards should in theory at least improve model standards and substantially reduce many categories of model risk, albeit with some possibly offsetting changes in systemic model risk exposures. Model risk management in the EU has not yet reached Fed-like levels of maturity, however we expect SR11-7 like measures to emerge as TRIM gathers pace.

Stepping back from the fray for a moment, we see an increasing divergence in supervisory perspectives regarding model value. Many US regulators view internal models as unreliable, and so wish to minimise their use. By contrast, European regulators take a more nuanced, Cartesian view of the discipline, and seem to believe that the internal model regime can be revitalised by increasing standards. Where these worldviews collide is in the Basel Committee discussions regarding the floors appropriate to model outputs. The results of these negotiations will have a significant bearing on model investment decisions in 2017 and beyond.

**Stress testing: Getting value from these increasingly tough prudential tests**

The fact that stress testing is a core part of the prudential regulation landscape now is old news. In 2016 UK banks performed their third annual concurrent stress test and European banks their second EBA stress test. The two stress tests are very different in terms of methodology as well as regulatory focus. But there is at least one major theme in common: while, broadly speaking, banks are upgrading their stress testing capability, they are being driven to integrate it more into their risk and capital management processes and are seeing value from it. This trend will continue in 2017, and the tests will continue to get harder.

**EBA stress tests**

In 2016, the EBA has completed another EU-wide stress test covering around 70% of banking assets. The results have shown the resilience of the EU banking sector as banks have drastically increased their capital base for the past five years. The average estimate of the sample’s starting point capital position is 13.2% CET1 ratio (as of 31 December 2015), which represents 200 bps higher than in 2014, and 400 bps higher than in 2011. Also, the hypothetical scenario led to a stressed impact of 380 bps on the CET1 capital ratio, showing the strong resilience of the sector and its ability to maintain decent capital levels in a deteriorating economic climate.
Although the 2016 EU-wide stress test did not include a pass/fail threshold, their results have been a key component of in the 2016 SREP exercise to establish pillar 2 guidance and requirement for banks to maintain the appropriate amount of capital.

While European banks have now a better understanding of these supervisory stress tests, most still consider it to be another regulatory requirement. In the coming years, we should expect them to implement or strengthen top-down stress testing framework as their business models and strategic processes are more and more challenged by the annual SREP exercise. In addition, in 2017 the EBA should publish its final guidelines on stress testing and supervisory stress testing which could push the sector to further integrate stress tests with risk management and business strategies.

**Bank of England stress test**
The annual concurrent stress test for UK banks has become one of the Bank of England’s key prudential tools and one of the most watched fixtures in the regulatory calendar since its inception in 2014. 2016 was no exception. While the quantitative results are revealing given the severity of impact, the most interesting observations are on banks’ processes rather than the outputs. This qualitative focus has not subsided over the years, even though the stress test is considered “BAU”.

UK banks have prioritised and invested huge amounts into stress testing. Teams are much bigger, systems and processes are more sophisticated and stress testing models are catching up with primary risk models. Also, importantly, banks are using the stress test to improve risk management and derive value.

By no means is the job complete. Firstly, the test continues to get harder as it evolves. The ‘exploratory’ scenario, the impact of the Bank of England’s developing modelling capability and the requirement to incorporate IFRS 9 credit loss forecasts all present operational and methodological challenges for the next time around. Secondly the Bank of England is not satisfied with the progress banks have made with their processes (in regarding model management, review and challenge processes and data quality).

Also, by finalising the FDFS data structure, adopting a somewhat predictable counter-cyclical scenario approach and sign-posting clearer guidance, the Bank of England is providing banks with a stable and supportive platform on which to further invest in infrastructure. This mitigates one of the key impediments to investment spend – uncertainty.

**V. STRUCTURAL REFORM AND RESOLVABILITY**

**Capital and loss absorbing capacity: The role of TLAC in holistic capital management**

In many regards, the CRR 2 package puts capital management in the spotlight. On the one hand, it sets out a comprehensive package to update the loss-absorbing requirements, including the implementation of TLAC, the associated recast of the MREL framework, and a common approach to bank creditors’ ranking in insolvency hierarchy. On the other, it revises the capital rules by splitting the pillar 2 capital component into a requirement and a guidance, confining its scope to micro-prudential risks and clarifying the stacking order of capital requirements.
Given the interaction between loss absorbing capacity and own funds requirements, a holistic approach to capital management is warranted. Indeed, it is key to ensure compliance with requirements on own funds and eligible liabilities in light of potential Maximum Distribution Amount (MDA) repercussions, given the outlined stacking order. As the package put forward clarifies the way forward, pending the expected overhaul of the capital buffers as part of the on-going review of the macro-prudential framework (proposals due by Q1), banks will now be able to focus on developing and improving internal processes including capital planning and issuance strategies, to optimise their funding structures and ensure compliance.

**The Single Resolution Board: Ramping up**

Fully operational since January 2016, the Single Resolution Board (SRB) got to work in fulfilling its mandate of ensuring orderly resolutions of failing banks with minimum impact on the real economy and public finances. 2016 saw the preparation of 70 full resolution plans and 30 transitional plans for the main banking groups in the Banking Union. Looking ahead, the SRB will perform horizontal benchmarking, and extend its resolution planning activities to all the banks under its remit while providing guidance to national resolution authorities.

Upon communication of their resolution plan conclusions, which is scheduled for early 2017, banks will be required to devise measures to improve their resolvability ex-ante, potentially including changes to their legal, operational and/or financial structure. Regarding loss-absorbing capacity requirements, the SRB will go one step further, after having set MREL targets at consolidated level in 2016, by looking at the quality and location of own funds and eligible liabilities within banking groups, while in parallel providing technical input to recent regulatory proposals to introduce TLAC and recast the MREL framework.
Also, the 2017 work programme reaffirms the focus on resolution readiness. To fulfil its mandate, the SRB needs to identify and address weaknesses in its operational capacity to deal with and resolve failing banks. To do so, initiatives launched last year, such as conducting dry-run exercises and enhancing the Crisis Management Manual, will be pursued to challenge the preparedness of the SRB to execute a bank resolution along with key stakeholders (NRAs, ECB, European Commission, etc.).
Below, we profile the latest in Anti-Money Laundering regulation, as well as the less well-defined yet critically important area of conduct risk. Regulatory compliance from a conduct perspective continues to be costly and onerous for firms, consuming huge amounts of resource and management time.

Conduct has been a hot topic for a good few years now. Its definition and scope is often ambiguous but it clearly falls outside the traditional risk domains such as liquidity, market, and credit risk. Regulators have taken vastly different approaches. Despite this global disparity, many regulators have shown a propensity to levy huge fines on firms that fall foul of their expectations.

I. CONDUCT RISK: THE EVOLVING REGULATORY APPROACH

Consider the difference in approach between the ECB for eurozone banks and the FCA in the UK. The ECB considers conduct risk to be the current or prospective risk to the institution’s earnings and own funds arising from inappropriate supply or wilful misconduct in providing financial services. Conduct risk, therefore, for the ECB is a subcategory of operational risk. For the FCA, while there is no single concise definition of conduct risk, they have become clearer and clearer on their approach to supervising such risks and their expectations of firms and the consequences of not meeting such expectations. The introduction of the Senior Manager and Certification Regime in the UK over the course of last year underscores the importance regulators place on personal accountability on risk issues such as customer conduct. This will continue to embed in 2017 as firms continue to refine roles and responsibilities and underlying controls and assurance mechanisms.
There are a number of key activities in line with the FCA approach, most recently expounded in their ‘mission’ published shortly after Andrew Bailey took charge, which gives an indication of the course the FCA is following. This mission includes various elements which should translate into elements of firms’ conduct risk frameworks as they are revisited this year, including:

**Consumer protection**
This is a statutory objective of the FCA and remains in focus; with a special focus on so-called vulnerable customers. As conduct risk frameworks evolve in banks, now is an opportune time to revisit policies and procedures along the entire product life cycle from new product development, to promotion advice and selling (including cross-selling), and post-sales customer interactions including complaints handling. An in-house view of which customers are more vulnerable should inform this.

**Redress**
Banks have their own processes for customer redress in terms of when it is needed and the process for executing it. As the FCA’s approach matures, banks should look at their approaches to ensure alignment with regulatory expectations.

**Disclosure and transparency**
This is specifically mentioned in the FCA mission with the implication that the FCA may dictate further guidance and restrictions on the product information provided to customers. Banks should review their already well-established policies on this, in light of assessments on customer and products referred to above, in order to avoid regulatory intervention.

The FCA has published feedback themes from this consultation, which indicate a strong desire for more and clearer communication with firms, and disparate views on the merits of principles based vs. rules based regulation. Expect the FCA to say more on this as the consultation on their mission ends on 26 January. And expect other European regulators to watch closely. While the FCA may have been the front-runner in conduct regulation, other regulators have taken note.

For instance, the joint committee of the European Supervisory Authorities published a consultation on 19 December last year on the risk and regulatory impact of banks employing ‘big data’ strategies and techniques in their business processes. This makes the point that technological advancements in data analytics is a main driver in innovation within the sector, but it comes with risks – foremost of them is conduct risk.

For example, as banks find new ways of analysing customer information and behaviours to influence credit decisions, how will they ensure that they continue to treat customers fairly and achieve the right customer outcomes? Or, as banks have access to more unstructured and potentially sensitive information about customers, how will they upgrade their data protection and information security policies and processes to ensure ongoing compliance with relevant regulations? In the lead up to GDPR implementation in mid-2018, this will become more important. These represent the new conduct risk challenges in this rapidly advancing technological environment.

Despite the fundamentally different nature of this risk type compared to financial risks, the impact on financial resilience is becoming more explicit and severe.

Last year, conduct risk was a major part of the Bank of England’s stress test. For some banks, it had a material effect on its stressed capital ratios and represented a potential ‘tipping point’ towards non-viability. This exercise presented
an opportunity for banks to really think about how fines and other operational risk losses might impact them in a stressed environment – something that can help improve their approach to managing conduct risk. Expect this trend to continue this year in the next round of stress tests and in banks’ other forecasting and planning activities.

Also, as the most visible manifestation of conduct risk is fines for operational risk failings such as mis-selling, this will factor directly into operational risk capital requirements under the latest Basel proposals for a revised framework. While this is still being debated in Basel, banks should be preparing by looking at how their conduct risk and operational risk frameworks and systems are able to generate, store and analyse reliable data relating to events and losses, as this will have a direct impact on capital requirements. There are many ways to slice and dice operational risk losses in terms of allocation to products, businesses, and periods of time so data capture and analysis are key to optimising these potentially punitive requirements.

So, conduct risk will remain a hot topic, as it will continue to evolve reflecting the rapid advancement in technology and banks finding new ways of doing business.

**II. THE 4TH ANTI-MONEY LAUNDERING DIRECTIVE AND THE FAST CHANGING ENVIRONMENT**

When the 4th AMLD 2015/849 was approved by the European Parliament in May 2015 ten years had already passed since the launch of the 3rd AMLD. This produced a major improvement to help the financial sector to combat the laundering of money from criminal activities and to counter the financing of terrorist activities. With the new directive the new recommendations of the Financial Action Task Force (‘FATF’) from 2012 were taken into account.
But meanwhile the world changed drastically after the terrorist attacks in Paris in November 2015 and in Brussels in March 2016, and also after the revelation of financial leaks such as Panama papers. Corrective actions were necessary suggesting that the 5th AML Directive will follow quickly. Other leaks or revelations in the future will indicate that necessary remediation or additional guidance will be necessary. The action plan of the European Commission in February 2016 targeted these amendments. This requires a different approach from the obliged entities and the competent authorities will strengthen their controls to ensure that appropriate follow up is done.

Some of the major changes in the Directive are the individual responsibility for the entities and the broadening the definition of tax crimes. Also a formalised risk assessment is needed, which identifies and evaluates risk in an up-to-date document, made available to the relevant competent authorities. The risk assessment needs to take in consideration the EU report which assesses areas of the internal market that are greater risk, the risks with each relevant sector and the most widespread means used by criminals to launder illicit proceeds. This report will assist the obliged entities in the risk assessment exercise and will be available in the summer of 2017 – recurrent every two years or more frequently if deemed necessary.

Other key elements of the 4th AML Directive include the major changes in the rules on politically exposed persons (PEPs) where the scope is extended to domestic PEPs and ones linked to international bodies and close relatives and associated parties. This results in an additional compliance workload.

The roll out of the central register of ultimate beneficiary owners will help firms keep track of known international money launderers. The different approaches within the EU will require an additional in depth understanding how these systems can be best put to use.

The right risk-based approach needs to take into account the myriad of risks and available information including:
- Ensuring a high level of compulsory checks on financial flows from high risk third countries;
- Enhancing the powers of EU Financial Intelligence Units (FIU) and facilitating their cooperation;
- Asset freezing measures;
- Alignment of definitions in the money laundering offences;
- Preventing the abuse of virtual currencies; and
- The use of pre-paid instruments.

Securing the budget for this ongoing and expanding compliance challenge is key. Investing in advancements in data analytics and process automation will be necessary; not ‘nice to have’.

Putting strong processes, controls and governance in place, fit for a bank are essential to avoid major fines that threaten to further diminish margins within the sector; but more importantly, to create a safer world.
It is hard to keep up with the rapid and unstoppable technological revolution happening in the financial services sector, but it certainly feels as though some of the hitherto experimental and seemingly fantastical ideas are becoming more of a reality now, and that 2017 could be the turning point, moving from proof-of-concept to tested commercial viability. It is becoming increasingly evident that technology and risk go hand in hand: technology poses new risks (cyber, data protection) but of course it can enable better management of risks too.

This section explores aspects of the fintech landscape in the context of new technologies enabling both new entrants as well as new business models and products at incumbents. Importantly though, we also delve into the regulatory response to all of this so far: how regulators are becoming more technology enabled themselves, whilst keeping an eye on the emerging systemic and firm-specific risks posed by rapid and fundamental technological change.

I. FINTECH: THE PROPHECY IS COMING TRUE

2016 was a year of true digital change for financial institutions; a turning point where the much talked about disruption became reality — moving beyond the proof-of-concept. Many innovative challengers have led the way towards a new and improved customer experience and cheaper services. As the fintech industry consolidates this year and as large incumbents become “fit-to-play” as service organisations with established technologies such as artificial intelligence (AI) and robotic process automation, customers will benefit from more contextual, entirely personalised experiences. 2017 will be the year of the prophecy is coming true; driving more transparency, better customer engagement and greater efficiency.

The removal of pain points from the customer journey

Some banks have begun to remove pain points in the customer journey and go well above the expected services; sometime approaching those of the hospitality industry. This is exemplified in the Private Banking “concierge” approach at HSBC and further measures to protect the privacy of their clients on the internet.

Other players are challenging the heart of the business model such as Paypal, bypassing the traditional risk models to achieve instantaneous flexible credit to SMEs. In the same area of small business lending, fintech outfits such as Kabbage have become so efficient at aggregating transactional data that financial institutions around the world have now partnered with them to benefit from their decisioning platform.

Finally, as banks recognise the value of acquiring, on-boarding and delivering innovation, the industry has benefited from a multitude of improvements across mobile services, and the removal of well know complex authentication frustrations through biometrics (MasterCard, BNP Paribas), turning online banking into customer relationship platforms sometimes supported by simply increasing contact centre flexible hours.

The creation of an innovation environment

For many, becoming “fit-to-play” in the digital space meant, first and foremost, developing a structured yet flexible approach to accessing data, with a view to integrating with the emerging ecosystem of bank-fintech partnerships. Projects concentrating on developing “data as a service” through robust Master Data Management frameworks and flexible data integration solutions are aimed specifically at “running the business”. Solutions such as MuleSoft’s Salesforce integration are making their way into financial services to make it easier to integrate CRM, ERP, and other applications.
Whilst regulations such as PSD II and Open API are paving the way for an open API ecosystem across Europe, the development of a flexible API architecture also represents a way for banks to monetise their digital assets and data and to provide consumers with secure, less expensive, and easy-to-use financial services. More importantly, such development will help these institutions to secure competitive advantage via differentiation. With a clear first mover advantage, the race is on.

Beyond the technology challenges, banks are also facing an organisational one: the restructure of work with much of the IT developments now being initiated or even driven by the business or marketing space as an answer to the customer pain point. Tribes, pizza team and other exotic terms have emerged in the organisation looking to create much of the same dynamics than those of a Google or Netflix – with great success. According to Bart Schlatmann¹, who until recently was COO at ING Netherlands, the approach of structuring some 350 squads in 13 so-called tribes has improved time to market, boosted employee engagement, and increased productivity.

The rise of the contextual and unique customer experience
AI and cognitive technology enables banks to accelerate digitisation initiatives, reduce costs and deliver personalised services.

In the past few years, robo-advisors have proven their efficiency in asset and wealth management automation helping professional investment advice go mainstream. This is especially true for the younger generation, the lower net-worth individuals who might not have qualified in the past for personal attention with the banks and generally those who might not have known where to start.

But beyond robo-advisors, AI has reached a critical tipping point and is making its way into organisations thanks to its capability of intelligently managing automated processes. In 2017 AI will expand its reach and start to become the engine of the entire banking experience.

From a client engagement perspective, the ability to develop systems that learn, adapt and respond autonomously rather than simply execute predefined instructions is already gaining traction with customer facing applications such as chatbots or cognitive agents. This is particularly prominent in the context of “conversational commerce” where chatbots appear to be a response to the need for financial institutions to have millions of on to one personalised conversations in an automated and cost effective manner.

From a middle and back office perspective, AI is driving changes across the compliance, services and regulation areas of the bank; enhancing or replacing traditional operations. Digital client on-boarding and KYC have now become a priority for banks with a number of specialised solutions ranging from big data KYC (KYC3) to centralised video authentication (ID Now in Germany) gaining momentum across the industry. Beyond this, cognitive solutions like those of IBM Watson and process automation robotisation such as Blueprism now provide enhanced cognitive decisioning and value, and translate into 24/7 fully automated service, instantaneous response and processing of clients’ recurring requests.

Finally, the emergence of blockchain technology applications across financial service providers such as the Luxembourg Stock Exchange (with blockchain smart contract and KYC) or banks themselves are starting to demonstrate the value of this new concept. Yet, whilst hundreds financial sector

— proofs of concept — were developed last year, much fewer players have industrialised the conceived design. Thanks to the significant investment channelled in the technology and a maturing industry, 2017 will allow the more reluctant to tame the technology but also to identify the relevant business cases that can be earmarked for blockchain transformation.

There is no turning back. There is no hiding. Enhanced access to data, improved processing time and the emergence of the machine learning capabilities have contributed to spread digitalisation across all areas of the financial services. Whilst such changes may be daunting (if not a little scary) to some of us, they represent the single most exciting opportunity for financial services: gaining back the trust of their customer thanks to the transparency, customer focus and efficiencies such technologies bring to the market.

II. SUPERVISORY RESPONSE: USE OF TECHNOLOGY AND ADAPTING TO NEW RISKS

From a regulatory standpoint, there is a move to technology-enabled supervision with regulators seeking to harness the benefits of the fintech trends and more specific regtech capabilities. CRR 2 mandates the EBA to develop a digital tool to assist banks in identifying which requirements apply to them and in keeping up with new requirements. There is a trend on the use of machine learning techniques and semantic latent analysis to analyse relationships between regulatory documents and the terms they contain. Such innovations will be key in satisfying rapidly evolving regulatory requirements.

The Bank of England in the UK is using its new ‘Fintech Accelerator’ to work with start-ups to develop proof-of-concepts in areas such as data analytics, information security, distributed ledgers to address its challenges as a central bank and banking supervisor. Also in the UK, the FCA has its ‘Project Innovate’ (est. late 2014) aimed at fostering innovation, using technology in achieving regulatory compliance. The European Commission created a fintech taskforce in December 2016 in order to shape its response to digital transformation in the banking sector and ensure that banks’ business models change to benefit from technological innovation.

Whilst some regulators are truly embracing technological advances in terms of their own processes and encouraging new entrants, they are also very alert to the risks posed by this new technologically enabled financial services ecosystem. This is certainly true in both the UK and Europe. The governor of the Bank of England, Mark Carney, has spoken about anticipating more intrusive regulation within the fintech sector including potential changes to the regulatory perimeter and prudential requirements. As another example, as mentioned in the conduct risk discussion above, the EBA’s consultation on the impact of big data on risks in the banking sector is a first step to informing an appropriate regulatory response. Of course, significant regulatory change in this respect cannot be expected this year, but this clear sign-posting should serve as a warning to firms to have a close eye on risk and governance to ensure the development of new technologies, processes and businesses are regulatory future-proof.

We are in the midst of a data revolution. Data is the key thread that is running through much of the enhancements to processes within both banks and regulators. Supervisors are showing a significant appetite for gathering and using firms’ data using their own staff, processes and models. The PRA has been doing this using the Firm Data Submission Framework (FDSF), which it uses for stress testing the large UK banks. The ECB is in the process of implementing AnaCredit, which is a vast credit risk dataset submission requirement imposed on all eurozone banks aimed at improving supervision as well as other aspects of central bank policy. When the regulator has its hands on more of the banks’ own data, it will place a very different focus on data management and quality within the bank and banks’ plans for infrastructure improvements.
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