the year ahead 2013

The impact of a decade of re-regulation in the Global Financial Services Industry

expertise applied. value added.
The Year Ahead is part of an ongoing research initiative into the major issues impacting the global Financial Services industry.

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the year ahead 2013
As 2012 draws to a close I can reflect on a year of significant transition for the Financial Services industry and our clients. I regularly visit our clients in all major financial centers and listen to their views on the evolution of the industry. During 2012, “long-term change” has been a consistent theme across all segments of the industry from investment to retail banking. Our clients are committed to adapting their business models to the new industry landscape and this effort is likely to last for many years.

Looking forward, 2013 marks the 12th year that Investance has been delivering specialist management consulting, technology and outsourcing services dedicated to the Financial Services industry. This year we will continue to expand and diversify our business into new markets, develop new offerings and invest in services to support our clients to achieve their objectives.

The landscape will continue to change in the coming decade as waves of both global and regional regulation reshape the marketplace. In response, financial institutions will adapt existing business models and develop new approaches that focus on efficiency, control and flexibility. During this time of change we maintain our focus on working with our clients to shape and deliver their regulatory reform response initiatives.

In addition to our traditional consulting services, we have expanded our business outsourcing capabilities to offer high-value knowledge process outsourcing from off-shore and near-shore locations. Furthermore, we have expanded our technology services by developing our end-to-end data feed automation tool Kirigami and the exciting new data management process tool Kirigami-DX.

In this year’s issue of The Year Ahead we focus on the re-regulation of the Financial Industry and aim to provide our clients with a range of insightful and practical articles on how to respond.

Our lead article looks at the history of financial regulation and what is ahead and proposes 10 ways in which financial institutions should prepare for the changes to come. We provide a roundup of views from our global locations in Europe, India, Asia and America including an insight from our new team in Canada.

Our colleagues working within the Investment Banking, Retail Banking, Insurance and Wealth Management sectors provide a viewpoint of the impacts of key regulations on each sector, from the data management requirements of Solvency II for Insurance industry and the broad ranging impact of Basel III to more specific tax initiatives with extraterritorial reach such as FATCA.

Finally we look at practical ways that financial institutions can change their businesses to both be compliant with regulation at the same time as reduce cost. Our experts in transaction management look at the path to achieving excellence in controls and reconciliations; we look at the rising importance of robust data management and take a fresh look at how financial institutions are outsourcing their business and knowledge processes as a way to achieve efficiencies like never before.

2013 is set to be another year of change and challenge in the financial industry, as the pieces of the regulatory jigsaw begin to fall into place, Investance specialists stand ready to assist you to navigate a path through the complex web of regulation.

Thank you for working with us over the past 12 months. I hope you will find The Year Ahead useful, if you would like to discuss any of the issues raised in The Year Ahead I would be happy to hear from you.

Best wishes for a successful 2013.

Franck Dahan
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A Decade of Re-regulation in the Global Financial Industry

The reshaping of the industry moves to the next phase.

The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.”

John Maynard Keynes, The General Theory of Employment, Interest and Money

The Financial Services Industry is four years into what will undoubtedly be described as a decade of unprecedented change. As regulatory deadlines begin to bite, 2013 will be a year that reveals how the industry has responded to waves of pressure from regulators around the world. However, it has not always been this way. To help chart the way forward, it can be helpful to take a look at some of the lessons of the past.

The de-regulation of the financial services industry that started in the early 1980’s on both sides of the Atlantic culminated with the repeal of the Glass-Steagall Act in the US in 1999 and the creation of the Commodity Futures Modernization Act of 2000.

This era saw a rapid consolidation in the industry and emergence of massive “Universal Banks” that under one umbrella offered routine banking, complex derivatives and a myriad of financial products in between; Insurance companies such as AIG were using complex derivatives, far from their normal business. Furthermore, the so-called “shadow banking” system grew to become a major component of the overall financial system, providing funding for many of the more risky activities whilst being lightly regulated.

By 2007 finance related services came to represent a substantial percentage of GDP in all major world economies and deregulation efforts were hailed as having created an environment of rapid innovation and better risk management. Left to their own devices banks, insurance companies and hedge funds created complex instruments to spread the risk while increasing the leverage in the overall system.

During this era the industry periodically experienced crises such as failure of Long-Term Capital Management in the late 1990’s or the Asian currency crisis; however these tended to be localized and with some (not inconsiderable) effort they were addressed without major long lasting economic impact. The global system as a whole was presumed to be safe and becoming safer due to what was described as “continuous innovation.”

Definition: Shadow Banking*

The shadow banking system is the collection of non-bank financial intermediaries that provide services similar to traditional commercial banks. It includes entities such as hedge funds, money market funds and structured investment vehicles (SIV).

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The power of hindsight

Looking back today the economic system was far from safe. Indeed, the global financial system came to a crashing halt as shockwaves resonating from the collapse of Lehman Brother’s on 15th September 2008 spurred the credit crisis. Fundamental mechanisms such as currency markets suddenly stalled and we saw major banks and insurance companies fail or needed bailing out.

The crisis that engulfed all major world economies prompted a fundamental re-think of the rules and regulations that govern the financial services industry. Politicians and legislators, policy makers and academics, as well angry taxpayers realized that without a strict supervision and rules, the financial services industry had grown too large and posed systemic danger to the overall economy.

In response, dozens of regulatory interventions have been devised, proposed, debated and approved. Following the G-20 meeting in Pittsburg in 2009, the United States passed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act, arguably the most comprehensive overhaul of the US Financial Services industry since the 1930’s.
How deregulation led to crisis

1986
- London “Big Bang”: sudden deregulation of the financial markets
- First Basel Accord Signed
- Riegle-Neal Interstate Banking and Branching Efficiency Act
- EU Financial Services Action Plan (FSA)
- Gramm-Leach-Bliley Act repeals Glass-Steagall Act 1933

1988
- Commodities Futures Modernization Act introduced
- Basel II published
- SEC approves Voluntary Regulation, releases net capital rules and creates Consolidated Supervised Entities (CSEs)
- Markets in Financial Instruments Directive (“MiFID”) Published

1994
- Growth in OTC Derivatives explodes increasing from $106 trillion in 2001 to $931 trillion in 2008
- allows growth of large US banks, eventually leading to emergence of “Too Big To Fail” banks
- 1994 Proctor & Gamble sees major issues from OTC derivatives trade orchestrated by Bankers Trust highlighting risk
- 1994 Creation of Citigroup as the first US-based universal bank

1996
- Fed Reinterprets Glass-Steagall to allow banks to increase investment banking activities
- Slow start to European bank consolidation

1999
- Fed Reinterprets Glass-Steagall to allow banks to increase investment banking activities
- Sudden deregulation of London “Big Bang”: “MIFID I” Published

2000
- Growth in OTC Derivatives again increases from $106 trillion in 2001 to $931 trillion in 2008
- Banks allowed to calculate capital using internal models
- SEC approves Voluntary Regulation, releases net capital rules and creates Consolidated Supervised Entities (CSEs)
- Markets in Financial Instruments Directive (“MiFID”) Published
- Slow start to European bank consolidation

2003
- Growth in OTC Derivatives explodes increasing from $106 trillion in 2001 to $931 trillion in 2008
- Banks allowed to calculate capital using internal models
- SEC approves Voluntary Regulation, releases net capital rules and creates Consolidated Supervised Entities (CSEs)
- Markets in Financial Instruments Directive (“MiFID”) Published

2004
- Second Basel Accord published
- Banks allowed to calculate capital levels using internal models
- Rapid increase in leverage by investment banks leads to unsustainable levels

2007
- Transformation of UK merchant banks to corporate structures attracts capital and increases volume of trading
- 2007: Bear Stearns leverage ratios average reach up to 1 to one and total common equity is shrunk by non-rapid, total-to-value as assets by 25%
- 2008: In March JPMorgan Chase buys Bear Stearns for $5.8bn loan from the NY Fed

2008
- Onset of global recession
- Lehman Brothers Collapse
- Major government bailouts: Fannie Mae, Freddie Mac, AIG, IBIS, Northern Rock
- Forced mergers: LloydTTSB and HBOS, Bank of America and Merrill Lynch · Lehman Bailout successfully manages Lehman Brothers US $53 billion interest rate swap default over 50,000 trades
- 2008: Managing Director

2009
- First Basel III Capital: Leverage and Liquidity requirements effective
- 2009: Basel III Capital: Leverage and Liquidity requirements effective
- April 2010: JPMorgan suffers $5.6bn loss from its CDO division trading CDS
- September 2010: OTC derivatives clearing begins
- December 2010: DTCC announces the launch of its global, OTC interest rates derivatives trade repository
- February 2011: DTCC announces approval to operate the Trade Information Warehouse for OTC credit derivatives
- September 2011: DTCC provides additional transparency on OTC Credit Derivatives by expanding its public release of CDS data to include historical information
- March 2009: ICE launches the world’s first central counterparty to bear CDS

2010
- Dodd-Frank Wall Street Reform and Consumer Protection Act
- October 2009: Lehman Brothers Collapse

2011
- Vickers Reforms deadline
- April 2011: FATCA withholding begins
- Dodd-Frank Swap Dealer Registration and Swap Data Repository deadlines

2012
- President Obama signs Dodd-Frank Wall Street Reform and Consumer Protection Act
- EPA announces approval to operate the Trade Information Warehouse for OTC credit derivatives
- September 2009: ICE launches the world’s first central counterparty to bear CDS

2013
- Dodd-Frank Swap Dealer Registration and Swap Data Repository deadlines
- July 2013: Volcker Rule Compliance deadline

2014
- Vickers Reforms deadline
- Volcker Rule definitions published
- August 2014: European Market Infrastructure Regulation (EMIR) passed into law

2016
- Vickers Reforms deadline
- Volcker Rule Compliance deadline
- Dodd-Frank Swap Dealer Registration and Swap Data Repository deadlines

2019
- Volcker Rule Compliance deadline
- Dodd-Frank Swap Dealer Registration and Swap Data Repository deadlines

A decade of re-regulation

Discussion & rule-making phase

Implementation phase

Re-regulation of industry begins

Disclaimer: This regulatory timeline is for indicative purposes only. Dates and deadlines are subject to change.
In Europe the EU jointly, and each state separately began working on a wide set of new regulations including reworking MiFID, introducing EMIR, Solvency II, and others. Globally, Basel III has been approved and is being implemented from 2013.

In the decade between the first G20 meeting in November 2008 through to when Basel III capital requirements become effective in 2019 we will see a comprehensive re-regulation of the industry. Every segment is facing a new, more comprehensive and strict set of regulations aiming to govern how the industry operates and the role it plays in the economy.

Our analysis identifies that broadly the new regulations will fall into two basic types:

1. Structure Regulations such as functional separation of institutions and entry requirements for example the minimum capital levels as set out in Basel III.

2. Business Conduct regulations – such as information disclosure rules, and pricing rules or rate regulation.

It is clear that a considerable uncertainty over the exact scope of the future regulatory landscape still persists. However, the reelection of President Obama in the US, the European sovereign debt crisis and slowdown of the world economy are giving a renewed push to the implementation of regulatory changes. As the dust begins to settle a detailed outline of the new environment is starting to emerge.

The new regulations aim to achieve 3 key goals:

− **Protection of the taxpayers** through increased capital buffers and the separation of “risky” activities from “utility” services. Basel III, the Volcker Rule, the UK’s independent Commission on Banking recommendations (Vickers Report) and Solvency II are clearly focused on these goals. Systemically Important Financial Institutions (SIFIs) are faced with additional capital buffer requirements and have to devise their own “Living Wills” that demonstrate how they can be “resolved” without exposing taxpayers to any future bail-outs.

− **Transparency in the markets** through exchange trading of most financial instruments, central clearing, reporting and disclosures. The Dodd-Frank Act, EMIR, MiFIR and other regulations aim to ensure that the opaque markets and complex instruments do not create massive imbalances in the system.

− **Increased accountability** of the financial services industry executives for their activities and performance. Legislative efforts are focused on forcing the financial services industry to adjust compensation models. For example it is a requirement of the Dodd-Frank Act that Financial Institutions must register members of the Board as “principals” plus shareholder efforts to have a say in executive pay aim to create a clear linkage with the long term risk adjusted performance of the financial services companies.

A host of new bodies will also emerge, including the Financial Stability Oversight Board in the US and European Systemic Risk Board comprised of central bank governors. Regulators, new and old, have a much broader mandate and a set of tools to oversee the industry and implement the new regulations.

Regulators across the globe are actively coordinating their efforts to achieve harmonization of regulatory regimes and to prevent possible “regulatory arbitrage”. While global banks fret about “extraterritorial impact” of the regulations in the US, such concepts as “substitute compliance” hint at the fact that over time every major economy is expected to adopt similar regulatory framework.

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**Major regulatory events prior to 2008**

**1986, London Big Bang** – abolition of fixed commission charges and of the distinction between stockjobbers and stockbrokers on the London Stock Exchange and change from open-outcry to electronic, screen-based trading, single banking license and the home country and mutual recognition principles in its second banking directive.

**1994, Riegle-Neal Interstate Banking and Branching Efficiency Act** – This bill eliminated previous restrictions on interstate banking and branching, allowing emergence of large US banks

**1996, Fed Reinterprets Glass-Steagall** – Federal Reserve reinterprets the Glass-Steagall Act several times, eventually allowing bank holding companies to earn up to 25% of their revenues in investment banking

**1999, Gramm-Leach-Bliley Act** – The bill repeals the Glass-Steagall Act completely, allowing creation of large universal banks in the US.

**1999, European Union publishes the Financial Services Action Plan (FSAP)** – The goal of the FSAP is to create a single integrated market in financial services in Europe.

**2000, Commodity Futures Modernization Act** – The bill prevented the Commodity Futures Trading Commission from regulating most over-the-counter derivative contracts, including credit default swaps

**2004, Voluntary Regulation** – The SEC proposes a system of voluntary regulation under the Consolidated Supervised Entities program, allowing investment banks to hold less capital in reserve and increase leverage

**2007, Markets in Financial Instruments Directive (MiFID) is one of the cornerstones of FSAP** – A European Union law that provides harmonised regulation for investment services across the 30 member states of the European Economic Area aimed at increasing competition and consumer protection in investment services.

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Top ten ways to respond to regulation and prepare for growth

Faced with the new environment, can the industry adjust itself to the new way of operating under significant regulatory constraints? Much is written about the challenges and some even consider that the “best days” of the financial services are long gone.

No one expects the industry to operate as it did in the 1970’s. The Worldwide economy is far more complex and developed, requiring an equally sophisticated financial system. However, no one should be expecting the push for re-regulation to subside. Therefore, to succeed financial services firms must find new and innovative ways to grow in the next decade while ensuring appropriate controls.

In our view Senior Management must have a comprehensive forward looking agenda encompassing not only product and service innovation but also consider the following ten key ways to respond and prepare for growth:

1. **Achieve compliance at the right cost:** Internal compliance departments will remain at the forefront of interpreting regulations to ensure that every corner of the organization is appropriately equipped to meet the new requirements. However, compliance comes at a cost and the organizations must look for ways to become more efficient in their approach to meeting regulatory mandates.

2. **Educate clients:** Operating under the constraints of regulations, Financial Services organizations must also ensure that their services are well defined, priced and understood by their clients. Each organization must make a substantial effort to engage their clients in a dialog to explain and educate them on the impact of the regulations.

3. **Optimize the business portfolio:** Many Financial Services firms will continue to review their diverse operations with a goal of identifying core assets, clients and businesses. Substantial progress has been made in disposing of assets and activities deemed non-core to free-up or preserve capital. However, untangling many years of rapid growth through mergers and acquisitions will prove challenging and will require significant investment of resources to accomplish.

4. **Right Size the Front Office.** In light of the regulatory and business changes, many financial services firms, particularly investment banks, are saddled with oversized Front Office organizations. All organizations must be flexible in their approach to staffing and have strategies in place to align the cost of the Front Office with the level of business activities.

5. **Focus on growth in Emerging Markets and fee-based businesses:** Investors will continue to clamour to access Emerging Markets to diversify their portfolios and achieve higher returns. The Latin American, Middle East, Eastern European and Asia-Pacific markets will attract global capital by offering significant growth opportunities. Banks, asset managers and other industry players must be positioned to offer global investors access to emerging markets as well as provide investors from those markets with access to the global opportunities. In the developed markets Wealth Management and Private Banking services will offer an attractive alternative to risk taking activities.
Secure funding and stability: Given the increased focus on capital, liquidity and funding, CFOs must focus on developing an optimal legal entity structure, finding the right balance of funding sources and granular allocation of capital costs to individual product lines. It is imperative that the cost of capital is fully and transparently allocated to the business.

Focus on Risk Management: Real-time risk management will be top of every CEO’s agenda. However, CEOs and CROs should not blindly trust the mathematical models. Instead, they should promote the culture of “risk awareness” throughout their organizations to ensure that everyone takes responsibility for identifying and mitigating risks.

Leverage data: Technical innovation gives the industry an ability to collect, process and use massive amounts of data that exist in multiple databases and data sources. Putting tools to harvest the Big Data at the disposal of the organization is one of the keys to product innovation. Furthermore the ability to integrate the data across all silos of the firm will give senior management an unprecedented view of performance and risks.

Achieve operational efficiency: Global and local COOs must focus on achieving operational efficiencies through better operational controls and automation. Better integration, breaking down silos, leveraging shared services and industry utilities are opportunities for COOs to deliver efficiencies. Indeed, the continued evolution and advancement of major industry utilities, the emergence of technical standards and changes in the market infrastructure could provide significant benefits to organizations able to leverage them.

Implement smart sourcing and location strategy: While the industry has been focused on outsourcing and offshoring many of its routine functions over the past 10 years, substantial additional benefits can be found from moving knowledge intensive processes to lower cost locations. Such transitions will allow organizations to achieve better economies of scale, reduce costs and to tap into the emerging or growing pools of highly qualified labor in countries like India, China and Brazil.

Conclusion

From the sudden deregulation stemming from the so-called “Big Bang” in London in the late 1980s to the repeal of Glass-Steagall in the late 1990’s, the financial services industry has witnessed both phenomenal growth but also increased risks for almost twenty years.

Whilst there were a few bumps along the way the era of large universal banks and complex derivatives continued unchecked. The events of 2007-2008 changed all that.

The Washington Declaration agreed by the G20 in November 2008 and commitments made during the Pittsburgh summit in September 2009 was the catalyst for a decade of action to redraw the financial services landscape. Four years on, the industry has made progress and with a raft of regulatory deadlines in due to come into effect over the next 12 months and throughout the next 6 years. The era of reregulation will prove a challenge but with a structured approach we believe the opportunities for financial institutions to build stronger businesses are there for those willing to adapt.
Four Corners
A view from around the world

Europe: Two steps forward, one step back

It has been another 12 months of upheaval and change for Europe. Economically, politically and socially, Eurozone countries and the wider EU have grappled with austerity, rising unemployment and unchecked sovereign debt. For the Financial Services industry it has been a year to regroup and rebuild – balance sheets, reputations and ratings – but it certainly hasn’t been plain sailing.

In The Year Ahead published in December 2011 we focused on the challenges facing the European Financial Services industry, zeroing in on four multi-year trends. The shifts in regulation and pressure on liquidity; the future of the Universal Banking model; private banking as a new source of growth; and impacts on operating models. 2012 demonstrated the importance of these 4 trends. Looking to 2013 and beyond, we expect to see organizations adapt to operate profitably in the new environment.

1. Regulation and liquidity

The European banking industry had a near death experience at the end of 2011 when liquidity in the global wholesale markets started drying up. Only actions by the European Central Bank (ECB) in the form of LTRO 1 and LTRO 2 prevented potentially major shocks to the system.

Crisis often leads to new regulatory frameworks intended to prevent such disruptions from happening again. In the Eurozone, current discussions are around the appointment of a single regulator for EU banks as a key part of the plan to create a ”banking union” to ensure the future solvency of the European banking industry. The proposal to appoint the ECB as the main regulator of 6,000 banks in the Eurozone has led to a fierce debate amongst members regarding the reach the regulator would have. Commentators expect that the ECB will, as a first step at least, take on responsibility for supervising the largest lenders, with national regulators accepting the need to curtail more”risky” trading activities funded by a cheap retail deposit base. In response they have been reducing the size of their balance sheets to boost capital.

As an example, for Société Générale the costs of exiting various Investment Banking operations. In France, banks are stepping into the breach. The UK’s RBS and Switzerland’s UBS are shrinking their Investment Banking operations. In France, banks are urgently trying to create a ”banking union” to ensure the future solvency of the European banking industry. The proposal to appoint the ECB as the main regulator of 6,000 banks in the Eurozone has led to a fierce debate amongst members regarding the reach the regulator would have. Commentators expect that the ECB will, as a first step at least, take on responsibility for supervising the largest lenders, with national regulators accepting the need to curtail more”risky” trading activities funded by a cheap retail deposit base. In response they have been reducing the size of their balance sheets to boost capital.

2. Universal Banking – consolidated but still viable?

Last year we asked the question ”Is the Universal Bank model dead as a result of market dislocations and regulatory changes?” Many organizations that aspired to become “Global Universal Banks” have dramatically reversed their strategy. The UK’s RBS and Switzerland’s UBS are shrinking their Investment Banking operations. In France, banks are accepting the need to curtail more”risky” trading activities funded by a cheap retail deposit base. In response they have been reducing the size of their balance sheets to boost capital.

While we see the ”Universal Bank” model continuing to operate in Europe, implementation of new prudential rules will require an evolution of this model. French and European banking CEOs will need to focus on the re-scaling and rebalancing of banking groups’ portfolio of activities to lower risks and meet new regulatory targets.

The economic impact of the retrenchment can be substantial. As the London Financial Times reported in December “Banks are no longer eager to take on the long-term loans required to finance infrastructure projects as they are soon to be hamstrung by new restrictions on lending and capital when the Basel III rules take effect next year.” Asset managers are stepping into the breach. This trend is likely to lead to substantial changes in the European capital markets and a growth in corporate bond issuance and credit markets overall.

3. Private banking as a new source of growth and security

Wealth Management and Private Banking have long been a staple of Swiss banks. However, faced with dwindling revenues and profits from capital market activities, many of the world’s largest Financial Services firms are looking to these areas as the new frontier to support long term growth. Examples are abundant. Goldman Sachs – the undisputed leader in trading – has announced a strategic focus on Private Banking and Morgan Stanley is building up the ranks of its Wealth Management division by acquiring the remaining stake of Smith Barney from Citi.

Although traditionally European banks have not actively pursued this business, it is now part of their core focus. Competition from both Swiss and US private banking
institutions, tougher income tax regimes, new tax avoidance regulations and shifting demographics are key trends shaping the Private Banking industry. In addition the High Net Worth (HNW) client segment is growing, in the Asia Pacific region and other Emerging Markets in particular.

However, regulations are likely to introduce complexities that will limit growth and require substantial investments in KYC and compliance processes as liabilities associated with failures in these areas can be substantial.

4. Direct and indirect impacts on the operating model – look for new frontiers.

The current market environment requires a significant redesign of banks’ operating models. Cost reduction and controls are top priority for the senior management. A continuous focus on cost reduction and budget control will maintain a strong drive in Outsourcing and Offshoring. Many leading European and French banks have significantly ramped up activities in their captive offshore locations. The next frontier is likely to be the mutualisation of specific operational services and functions within and/or across banks.

There is a considerable debate about the state of the US economy as the recovery is not proving to be as robust as many would have liked. The Federal Reserve continues to play an activist role in the markets impacting bond trading; proposed changes in the tax laws that will increase capital gains and dividend tax rates are increasingly influencing investment decisions; and the Sovereign debt crisis in Europe does not seem to be coming any closer to conclusion. As a result, many investors are being cautious, which impacts market volumes and can introduce excessive volatility. This environment does not bode well for capital markets players.

North America: Looking up, but not out of the woods yet

2012 may prove to be as important for the Financial Services industry in the United States as 2010 when President Obama signed into law the Dodd-Frank Act. The November elections brought a degree of political certainty and it is now clear that the Dodd-Frank Act is unlikely to be repealed or even significantly watered down. Over the past two years since the passage of the DFA regulators made substantial progress on rulemaking front. By the end of 2012 the major components of the new regulatory regime are being put in place. January 2013 will usher in several major changes in the OTC Derivatives markets and many of the European banks operating in the US will have to deal with considerable uncertainty stemming from the differences between the European and the US regulatory regimes. However, we expect that in 2013 many of these uncertainties will be finally resolved.

Very few events in 2012 had such a large impact on the industry as the loss tied to complex derivatives incurred by JP Morgan Chase’s Chief Investment Office. While the bank had sufficient capital to withstand more than $5 billion loss, it highlighted the need to monitor banks’ trading activities more closely. Indeed, this incident became one of the main arguments for implementation of the Volcker Rule. Furthermore, many financial services organizations are taking a much harder look at their own organizations to ensure that risk management processes are able to flag any potential risks before they result in major losses.

We see US banks continuing their efforts to “right-size” their organizations as they have been doing over the past several years following the credit crisis. Many of them are reviewing their retail branch networks and optimizing their footprint. The past year saw many of the largest banks announce layoffs within their Investment Banking divisions and business sales/divestures. Some talent is moving from the sell-side to the buy-side where hedge funds offer an attractive alternative to previously lucrative positions on the trading desks. As we noted in The Year Ahead 2012 last year (published December 2011), hedge funds will continue to grow and will play an increasingly important role going forward given the impact of the Volcker Rule on traditional banks.

North of the border, Canadian banks have withstood relatively well the vagaries of the economic situation, however some say we are not out of the woods yet. Given record high consumer debt levels, the anticipated increase in interest rates and the cooling of the housing market that many are predicting, Canadians could very quickly find themselves in a precarious position.

Source: Financial Times, Article, published December 9, 2012: Asset managers scramble to step into the funding breach.
For banks, the shrinking loan loss provisions, and in some cases their reversal, throughout 2012 could come to an abrupt halt putting more pressure on already slim margins.

Canada is not an exception in the global drive to better regulate the industry. Indeed, regulatory change is the driver behind the development of sophisticated regulatory response frameworks by Canadian banks that not only will ensure compliance with G20 objectives but also manage evolving impacts of regulations written in non-G20 countries.

Much like US financial services organizations, Canadian firms will maintain emphasis on cost controls and further adjustments to operating models throughout 2013. Product innovation, particularly in the arena of mobile banking, and international expansion beyond G20 will pick up speed. With a highly mature retail market Canadian banks can no longer depend on ‘out-pricing’ their competitors to gain market share and fulfill their growth mandates.

It is clear that the global economy is at a crossroads, and the financial services industry’s near-term prospects depend on the direction of the economic development. While it is unlikely that the industry will come back to its hey-days of 2006-2007, we see it stabilizing and adapting to the new regulatory and market environments.

Asia: An economy still Growing

One of the first things you notice when you visit Asia is the feeling that the impact of the recent credit crisis is not being felt on the same parallel as Europe or North America. The Asia markets are still not as buoyant as they have been in the recent past; in spite of this most of the Asian markets have risen sharply due to foreign investors being more bullish towards Asia; in particular the H-share market (which lists Chinese shares in Hong Kong) has rallied in recent weeks gaining a total of 15% since August.

A recently published study undertaken by OECD supports the potential for continued growth over the next 4 years of ASEAN economies to levels not seen since the credit crisis. This is all happening in spite of a slowdown in China.

With the recent acquisition of the LME by Hong Kong Exchange (who saw off competition from the CME Group and the Intercontinental Exchange), Hong Kong is set to capitalise on the demand for commodities and commodity derivatives, which is expected to grow in China as will the demand for Renminbi denominated products.

Regulation

The Dodd-Frank Act continues to facilitate further fragmentation of the global OTC Derivative markets. As a result of the varied implementation of OTC derivative reforms regulatory arbitrage has occurred between East and West which in turn is enabling Asia to attract more of the OTC volumes; although it does so at the risk of repeating some of the mistakes seen during the 2008 credit crisis.

With varied and duplicitous regulations (in particular for cross-border transactions) there will be even further fragmentation and increased risk. It is therefore essential that there is further consultation and collaboration between the regulators themselves and the various market participants.

One other central clearer to watch out for in Asia is LCH. Clearnet who are likely to look to Hong Kong and Australia as part of their Asia strategy. Any possibility of a pan-Asian clearer much like the pan-European service provisioned to virt-x would make a lot of sense in Asia. At the very least some lessons can be learnt from the significant expertise and experience LCH. Clearnet could bring to the table.

Private Banking

As high net worth individuals continue to increase in Asia so does the demand for increasingly sophisticated products. This sector of the banking industry is extremely competitive and it is becoming difficult for banks to differentiate themselves from their peers.

In addition to the tight spreads between a numbers of the Private Banks – there are a number of regulatory challenges and conflicts that are significant for continued growth in this sector. Examples of this are the classification of individuals as retail investors or professional investors the ramifications for which include, commission rules, the introduction of MiFID II and enhanced KYC requirements.

Extending into 2013 the key focus for change activities within the Financial Services sector will continue to be heavily driven by the evolution of the regulatory environment.

Regulatory requirements will be driven at a global level and more increasingly at a regional level, including areas such as central clearing, trade reporting, liquidity management and capital adequacy.
As a result of this continued focus an opportunity has presented itself for both the risk and compliance functions; the opportunity to undergo a transition towards an enterprise-wide operating model where both traded risk, operational risk and compliance operate in a more coherent and therefore cost efficient manner.

It is this evolution that will underpin and drive the ability of financial institutions to gain a greater share future revenue pools. In essence the evolving operating model will help to better differentiate competitors not only as risk managers but also on a cost and efficiency basis.

India: A positive economic outlook for growth

As the founding member of the BRIC club, India has been one of the undisputed leaders in the emerging markets growth story of the last decade. According to D&B, the Indian economy is expected to reach US$5 trillion by 2020. India's Real GDP is expected to register an average growth of around 9.2% during 2011-2020, on the back of robust private consumption demand, increased infrastructure spending, substantial growth in investment activity and strong growth in the services sector. According to D&B’s estimates, growth in the services sector is expected to average at 10.1% during the next decade, largely driven by robust growth in financial services, hotels, transport as well as communication.

However, recent outlooks into its growth prospects for 2013 are starting to diverge. A recent report by the Organization for Economic Cooperation and Development’s (OECD) indicated that India’s economic growth is likely to rise to more than 7.5% in 2013 and overtake China’s pace of growth by 2020. However the OECD report is in some notable contrast to the International Monetary Fund’s view on India’s growth for 2012-13. The IMF lowered India’s economic growth forecast by 1% to 5-6% for 2012-13.

Nonetheless, a cyclical upturn in investment, stronger external demand and the effects of recent monetary easing are expected to boost growth while also perhaps stock reducing iflation and rupee depreciation. Government policy uncertainty and high inflation could dampen the investment climate.

Looking at the Indian financial services industry, commentators estimate that the Indian banking sector is poised to become the world’s third largest by asset size by 2025 and that the US$41 billion Indian insurance sector will continue to grow at a rate of 32-34% annually. Indeed, the Indian banking sector displayed remarkable health and resilience during the recent financial crisis compared to the more advanced economies. India weathered the impact of the crisis on global financial system mainly due to a robust regulatory and supervisory framework implemented in the early 1990’s, market restrictions and limited exposure to the global banking system coupled with timely policy actions to manage liquidity.

The growth story of the Indian financial services industry is set to continue and as the government works to relax the licensing of new banks and make it easier for foreign banks to do business in India we expect to see changes to the financial landscape.

The G20 regulatory agenda has played a significant role in shaping Indian initiatives to strengthen the regulatory and supervisory framework post-crisis. The Reserve Bank of India’s reports that the country is making good progress in adopting new techniques in supervisory assessments. India has also moved ahead on its agenda to modernize and improve the financial infrastructure with reforms in the financial markets and the payment and settlement system which enhance the efficiency of the financial sector - a crucial input in the real growth of the economy.

The evolution of regional and global reforms have added new emphasis on Indian plans for second generation financial sector reforms originally tabled prior to the 2008 crises. These reforms are intended to beyond meeting the regulatory challenges set by the G20 to be fit for purpose to meet the requirements of a high growth economy and promote development, both in the short and medium-term.

The position of India as a key financial research hub of the world looks set to be strengthened as more and more financial institutions look to tap into the large pool of talented professionals and specialized domain workers and firms offering Knowledge Process Outsourcing (KPO) services. A report on KPO sector in India by ASSOCHAM, the leading industrial body of India, highlights how earnings from the KPO industry in India were $8 billion in 2011 and are expected to grow at a rate of 25-27% by the end of the year 2012.

With all the challenges associated with rapid growth and evolving infrastructure, India will remain a top priority for the global financial services organizations for many years ahead.

Source: October 2012 Update, Financial Services - India Brand Equity Foundation
Source: Reserve Bank of India Report “Benchmarking Indian Regulatory Practices to the G20 Financial Reforms Agenda”
Part 1:

Forward thinking for financial services

Insights, comment and analysis on the global regulatory reforms impacting the Financial Services industry
Investance: the year ahead 
2013
Volcker, Vickers and Liikanen: The path to a better protected banking system?

Today, almost four years into the era of re-regulation, the financial services industry is faced with complex, somewhat contradictory and, in some instances an incomplete regulatory framework. The Dodd-Frank Act, EMIR, MiFID, MiFIR, Basel III and other regulations have created a tangled web of new rules that aim to change the way the industry operates for the better. A key component of all these regulations is the separation of risky trading and investing activities from more mundane retail banking.

The Volcker Rule in the US and the UK’s Independent Commission on Banking recommendations (dubbed the Vickers Report) are the two most advanced regulatory approaches to separating risky trading activities from retail banking. Both aim to address problems arising from the integrated business models used by SIFIs before the crisis. Both have similar philosophical underpinning but are taking very different approaches to achieving their goals.

While the Volcker Rule essentially prohibits covered banking entities from engaging in proprietary trading and investing in hedge funds, the Vickers Report recommends ring-fencing retail banking operations within existing universal banks. Conceptually, both approaches could ensure that the risky trading activities do not topple a major bank.

On the 2nd October 2012, after 6 months of intensive work, the team of experts assessing the need for structural reforms to the EU banking sector under the leadership of Governor of Bank of Finland Erkki Liikanen delivered their recommendations for future of the European banking landscape. The goal was to consider if additional regulation to clarify the banking structure is necessary to avoid a default, consider the consequences of such an event on the wider economy at the same time as improving retail client protection.

Arguments can be made to support all of the approaches. The reforms proposed by Vickers implicitly recognize the difficulty of separating capital markets activities from commercial banking. It also acknowledges that there are synergies that large universal banks can realize from engaging in both retail banking and capital markets activities. Therefore, the focus of the Vickers reform is on protecting the retail banking operations within large universal banks at the time of the stress.

On the other hand, proponents of the Volcker Rule aim to achieve hard separation of risky trading and vanilla banking activities by effectively forcing large banks to choose the business they want to be in.

A number of key questions are being asked:

- Can either one of these approaches succeed in achieving policymaker’s goals of protecting the core banking system and ultimately taxpayers? Or is today’s financial services industry too big, complex and influential to be regulated in any meaningful way, without leading to unintended consequences of any attempts at stricter regulation?

- Will specific rules clearly separate risky trading activities from core banking or will this result in a lower appetite to extend credit due to a perceived inability to hedge?

- Will higher capital requirements ensure that risk is appropriately priced and managed or will this simply lead to higher cost of available funding to the economy, thus stifling the growth? These broad questions are at the forefront of global debate and must be addressed in a consistent, comprehensive way.
The path to a global regulatory regime

It must be noted that while the Volcker Rule in the US and the Vickers Report in the UK have been proposed, in continental Europe countries within the Eurozone that are battling a sovereign debt crisis it is taking longer to implement. The Liikanen Report confirms the need for further reforms and addresses the perceived gaps in existing regulation such as MiFID and UCITS with the following focus areas:

- Supervision and regulation must focus on tracking and addressing systemic risks at a macro-economic level.
- Consumer protection (in the retail banking sense) is not explicit enough though MiFID and UCITS, as they do not force banks to clearly explain to clients which products are constructed using complex derivatives.

The conclusions and recommendations of the group tend towards the recommendation of the effective separation of activities considered “risky” as this approach would secure the core activities of retail deposits and protect the delivery of financial services to non-financial sectors of the economy, protecting them from future shocks.

As a result of the diverse role that large banks play in different regions, a consistent and comprehensive approach to regulation must be flexible enough to accommodate specific regional nuances without creating the opportunity for regulatory arbitrage.

The development of a global financial regulatory regime will be a long and iterative process that will involve all stakeholders, including legislators, policymakers, industry practitioners and end users in all major economies. It will incorporate limits on specific types of activities (as the Volcker Rule does for proprietary trading) as well as broader regulation of capital requirements (such as Basel III).

Despite the challenges of building a global regulatory regime, it is likely to be centered on the differentiation between and the monitoring of permitted and prohibited activities. The burden of supplying the regulators with appropriate information and data on a timely basis will fall on the industry.

“Looking at past regulations such as Sarbanes-Oxley and Basel II it is clear that costs of ongoing compliance are likely to be several million dollars per year.”

It is expected that cost of compliance will be significant. As an example the OCC in the US estimated the cost of implementing the Basel II Regulatory Framework to be $21 million for a large bank. As it is highly unlikely that these regulations will go away, banks need to gear up for the cost implications of implementation.

1 Source: Networks Financial Institute: The OCC estimated that a typical bank utilizing the full Basel II regulatory framework faced a total compliance cost of about $21 million.
<table>
<thead>
<tr>
<th><strong>Scope</strong></th>
<th><strong>Volcker Rule</strong>&lt;sup&gt;2&lt;/sup&gt;</th>
<th><strong>Vickers Report</strong>&lt;sup&gt;3&lt;/sup&gt;</th>
<th><strong>Liikanen Recommendations</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>The rules define a covered banking entity very broadly to include:</td>
<td>All UK banks and bank holding companies that engage in services that mandatorily belong to the ring-fence plus UK subsidiaries of foreign Banks offering ring-fenced services.</td>
<td></td>
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<tr>
<td>✓ any insured depository institution;</td>
<td>✓ any affiliate or subsidiary of any of the above.</td>
<td></td>
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<tr>
<td>✓ any company that controls an insured depository institution;</td>
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<tr>
<td>✓ any company that is treated as a bank holding company for purposes of the IBA, and</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>✓ any affiliate or subsidiary of any of the above.</td>
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<tr>
<th><strong>Approach</strong></th>
<th>Prohibition of proprietary trading which is broadly defined as engaging as a principal for the trading account of a banking entity in any purchase or sale of one or more covered financial positions. This relates to short term trading.</th>
<th>Ring fencing of retail activity which aims at separation of UK domestic retail banking services (ring fenced banks) from global wholesale/investment banking services. The following activities would be prohibited for ring fenced banks:</th>
<th>Two options are proposed:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Permitted activities include:</td>
<td>✓ any service which would result in a trading book asset or which result in a requirement to hold regulatory capital against market risk</td>
<td>✓ any service that could hinder the smooth resolution of a ring-fenced bank</td>
<td>1. The application of a non-risk weighted capital requirement on trading activities in addition to the Basel risk-weighted requirements for banks with significant trading activity. Followed by separation of banking activities subject to a supervisory evaluation of the credibility of the recovery and resolution plans they have in place based on a clear set of common EU-wide criteria</td>
</tr>
<tr>
<td>✓ underwriting</td>
<td>✓ services that increase the exposure of the ring-fenced bank to global financial markets and market volatility</td>
<td>✓ Immediate functional separation of significant trading activities</td>
<td>✓ Produce an effective and credible RRP (Recovery and Resolution Plan)</td>
</tr>
<tr>
<td>✓ market-making</td>
<td>✓ services that involve taking risks which are not integral to the provision of payment services or the direct intermediation of funds between savers and borrowers within the non-financial sector</td>
<td>✓ In addition to a number of other requirements including:</td>
<td>✓ Use of specific bail-in instruments</td>
</tr>
<tr>
<td>✓ hedging activities</td>
<td>✓ services provided outside the EEA</td>
<td>✓ Steps to strengthen the governance and control of banks</td>
<td>✓ Services which result in exposure to a non-ring fenced bank or non-bank financial institution.</td>
</tr>
<tr>
<td>✓ investing in obligations of the US Government and states.</td>
<td></td>
<td></td>
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<tr>
<td>Strict limit on investments in hedge funds to 3% of Tier 1 capital</td>
<td></td>
<td></td>
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<tr>
<td>Territorial reach</td>
<td>Volcker Rule</td>
<td>Vickers Report</td>
<td>Liikanen Recommendations</td>
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<tr>
<td>The rules specifically limit the extra-territorial effect by permitting international banks to engage in proprietary trading and to invest in funds solely outside the US.</td>
<td>UK specific</td>
<td>EU Banking Institutions</td>
<td></td>
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<tr>
<th>Structural impact</th>
<th>Volcker Rule</th>
<th>Vickers Report</th>
<th>Liikanen Recommendations</th>
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<tbody>
<tr>
<td>Banks or Bank Holding Companies subject to the rule cannot house affiliates, even as separately capitalized and independent subsidiaries, that engage in prohibited activities.</td>
<td>Ring-fenced banks can co-exist within the same group as affiliates offering prohibited services. However, they must do so as separately capitalized, independently managed subsidiaries.</td>
<td>Legal separation of certain, particularly risky financial activities from deposit-taking within banking groups. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with the securities and derivatives markets. The new legal entities set up for trading activities can operate though a bank holding company. Separation would only be mandatory if the activities amount to a significant share of a bank’s business (assets held for trading and available for sale exceed a threshold of 15-25% of the bank’s total assets or EUR100bn), or volumes considered significant from the viewpoint of financial stability.</td>
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<tr>
<th>External links and activities</th>
<th>Volcker Rule</th>
<th>Vickers Report</th>
<th>Liikanen Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>No links can be established that seek to circumvent prohibition of proprietary trading and funds investing.</td>
<td>No such links can be established without prior regulatory approval except with such entities within a ring-fenced bank’s own group. Within group, such transactions must be conducted at arms-length and be subject to prudential constraints on intra-group exposures.</td>
<td>Legal separation of certain, particularly risky financial activities from deposit-taking within banking groups. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely linked with the securities and derivatives markets. The new legal entities set up for trading activities can operate though a bank holding company. Separation would only be mandatory if the activities amount to a significant share of a bank’s business (assets held for trading and available for sale exceed a threshold of 15-25% of the bank’s total assets or EUR100bn), or volumes considered significant from the viewpoint of financial stability.</td>
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<tr>
<th>Deadlines</th>
<th>Volcker Rule</th>
<th>Vickers Report</th>
<th>Liikanen Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implementation Deadline = July 21, 2014</td>
<td>Regulation Finalized = May 2015</td>
<td>Proposal at this stage</td>
<td></td>
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<tr>
<td>Implementation Deadline = 2019</td>
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1The “Volcker Rule” is part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 and introduced in Title VI the “Bank and Savings Association Holding Company and Depository Institution Regulatory Improvements Act of 2010”

What to do in the environment of regulatory uncertainty?

It is not our goal to try to guess the final shape that exact regulations will take. In our ongoing discussions with clients, one recurring comment we hear is that they are reluctant to take specific steps or make substantial changes until regulations are finalized. Is this a viable approach?

We believe that the financial services industry, and in particular the largest players, must accept that the regulatory uncertainty will continue for the foreseeable future. Further, regulations will evolve and change over time. Faced with this, every financial services firm should focus on building up their strategic flexibility to comply when the regulations become final.

We have identified three key areas that banks need to pay attention to and invest in today:

1. **Organizational simplicity**

   Today’s financial services firms, particularly large global banks, are a complex web of interconnected legal entities set up in various jurisdictions supporting various business activities. While this structure served banks well when there was little or no cost of compliance, regulatory reporting and capital, it very well may become prohibitively expensive to operate in the new environment.

   Indeed, with regulators looking to understand each firm’s risk profile, organizational complexity stands in the way of regulatory reporting. To meet the requirements of regulators in various jurisdictions, financial services firms must be able to quickly and accurately identify within their business mix what activities should be reported, where these activities are captured, if they captured in a consistent manner and how required reports can be created.

   Furthermore, as the cost of capital is increasing and funding is becoming more challenging, maintenance of a large number of legal entities becomes costly and inefficient. Only so much can be achieved by optimizing existing funding approaches before limits are reached and wholesale rethink of the legal entity structure is required.

2. **Data transparency**

   Access to complete, accurate and timely data has been a key business requirement for financial services firms. Recent regulations made this an absolute must. Just to comply with the requirements of the Volcker Rule, many large banks will need to produce a comprehensive set of metrics to prove that their trading activities do not violate the ban on proprietary trading. Other regulations set specific compliance rules based on the type of counterparty, client and instrument.

   Reporting to industry data repositories and regulators requires even larger sets of data to be supplied at higher frequency and retained over longer periods of time. In addition to regulators, clients, rating agencies, investors and other stakeholders clamor for data transparency to understand what kinds of risks are embedded in large financial services firms.

   However, the industry today struggles with internal data problems. Many financial services firms were built over the past decades as a result of multiple mergers leaving a legacy of disparate systems, processes and data stores. The lack of industry standards and high costs of retrofitting existing systems to comply with even limited standards led to a mess of tactical solutions implemented while waiting for “strategic” ones.
Solving “The Data Problem”

Why is “the data problem” so difficult to solve and more importantly, what has changed to ensure that this time it will be different? Despite the difficult business environment and cost pressures, many financial services firms are continuing to invest in their “data assets” and in developing an “enterprise data architecture”.

The core of these initiatives are focused on identifying golden sources of data, ensuring enterprise-wide compliance with standards and gradual transition of legacy platforms to new data sources.

Investment in improving data quality will pay dividends over a long time. Even partial wins will give financial services firms better capability to meet regulatory requirements, enforce compliance and communicate to external stakeholders. One could argue that having access to accurate data on a timely basis is a prerequisite to being able to operate in today’s volatile markets. Giving executive management the ability to accurately understand risks and to identify potential business impacts of new regulations is critical to ensuring strategic flexibility.

3. Operational sophistication.

The financial services industry, in particular capital markets firms, have been investing in their technology platforms as a way to boost revenues, launch innovative products and improve client services. Many of them spent a significant amount of resources on developing trading systems to manage complex derivatives or to provide the capability to trade in the stock markets using sophisticated algorithms.

Most of these investments were geared to supporting new businesses or products at the expense of streamlining processing and control systems. In many cases Risk Management, Finance, Operations, Compliance and other support functions are still operating on inefficient, complex and disparate systems with heavy manual interventions.

As compliance burdens are likely to increase over time, the industry must address the investment imbalance and substantially enhance capabilities of processing and control systems. This effort should be focused on further automation of real-time transaction flows, increase in data quality and development of data warehousing and retrieval capabilities.

Improvements in systems must be closely followed by improvements in business processes to reduce the operational cost while increasing operational sophistication.

Coupled with legal entity architecture and data architecture, investments in operational and support systems will build a platform to support future business.

Whatever shape regulations take over time, financial services firms must approach their design with the goal of achieving flexibility to meet regulatory requests with the lowest possible cost – not an easy task given the complexity of some new regulations. Although the rulemaking bodies have so far been accommodating to industry pleas that they are simply not equipped to meet strict requirements, as deadlines approach time is running out and the patience of regulators is beginning to wear thin.

For more information about how Investance can assist your organization with its regulatory response initiatives please contact

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Laurence Barroin, lbarroin@investance.com

*Csource: Wikipedia: The Winchester Mystery House is a well-known mansion in Northern California. It once was the personal residence of Sarah Winchester, the widow of gun magnate William Wirt Winchester. It was continuously under construction for 38 years. Under Winchester’s day-to-day guidance, its “from-the-ground-up” construction proceeded around the clock, without interruption, from 1884 until her death on September 5, 1922, at which time work immediately ceased. The Queen Anne Style Victorian mansion is renowned for its size and utter lack of any master building plan.*
The impact of regulation on the French retail banking industry

Getting Back to Basics

At a global, regional and local level, an unprecedented range of regulatory initiatives are being implemented or refined with the objective of increasing safety of the financial system and improving taxpayer protection.

- Initiatives to separate risky activities from routine retail banking such as Volcker Rule, Vickers Report in the UK plus a new bank ring-fencing legislation for France is expected by December 2012. While regulatory patterns may appear similar, the scope and severity of national initiatives vary from one country to another.

- Several European Union directives are to be implemented by 2014 covering mortgages, packaged retail investments as well as the much publicized MiFID II and SEPA.

- On a global basis, the Basel III regulatory framework is due to reshape the global financial landscape and shall be applied in the EU via CRD IV.

The impact of Basel III rules will be felt by all financial services firms from investment banks to retail banks and consumer credit players. Whether it is national or local banks, new rules will push banks to redefine their business and operating models dramatically, to address huge pressure on their ROE.

In France, regulation is exacerbating trends already present in the market. On the liability side of the balance sheet, competition remains fierce for deposits, whilst on the asset, side restrictions on how banks offer consumer credit, especially on the highly profitable business activities of the past is a threat to the traditional banks.

A new gold rush: the competition for consumers’ savings

Over the past few years, French banks have launched a range of new successful savings account products for retail customers, including regulated, non-regulated and fixed-term deposit accounts. These accounts are designed to meet consumers’ expectations, address changes in their behavior and find new ways to meet regulatory requirements:

- In a time of deep uncertainty in the markets, customers become risk adverse – the net outflows and low return rates (down from 6per cent 10 years ago to less than 3 per cent) in life insurance products demonstrates this; whereas savings accounts experienced record high net inflows (thanks to comparatively competitive rates).

- The distribution of ‘A’ passbook regulated savings accounts (standard French savings account) has been liberalized allowing all retail banks to offer this extremely popular product to their customers. Although two-thirds of these will later be centralized at the Caisse de Dépôts level (a publically owned long-term investment organization). The success of this type of savings accounts in as indicator of consumer’s aversion to risky products. Whilst the opportunity to offer this type of account is attractive to banks in the short-term, it will not help them to comply with Basel III liquidity requirements, as they threaten the bank’s own deposit account offerings (non-regulated or fixed-term deposits) as a source of capital.

The fight for savings has resulted in aggressive promotional rates above 5per cent and an increase in disloyal “rate hunter” customers looking for bargains from competitors willing to reward those that commit for longer periods with bonuses and better rates over time.

Efforts deployed by banks to adapt to the regulatory environment through the rebirth of fixed term deposits are now coming under scrutiny by the French Prudential Supervisory Authority (FPSA). The FPSA has published a recommendation that will come into force in June 2013 aimed at enhancing transparency of customer information. Further changes in the savings market are expected as the implementation of Basel III requirements, when clarified, may lead to unexpected side effects.
Consumer finance at crossroads – the end of revolving loans?

After a first wave of regulatory changes in 2010 (under the “Lagarde Law”) aimed at increasing consumer protection and transparency, the fate of consumer credit and especially revolving loans are under threat in France. While a ban on revolving loans (first considered in the summer of 2012) is no longer on the agenda, the new government would still like to add some new controls to the financial activity regularly accused of being the main source for over-indebtedness.

The Lagarde Law focuses on the following improvements:

— Improvement in the disclosures to customer to ensure that they are informed and can make sound decisions before signing any credit agreements
— Mandatory control by the lender of customers’ credit and solvency
— Set up of stricter rules regarding revolving credit cards and loans: installments to be proposed as an alternative for amounts greater than 1000 EUR, defined maximum durations for consumers to pay back loans, automatic cancellation of credits if not used within 2 years, and cash payment as a first option for card holders

The French Association of Specialized Finance Companies (ASF) registered a significant drop in new revolving loans issued in both 2011 (12 per cent) and 2012 (7.7 per cent), leading to a balancing of the credit portfolio in favour of personal loans and instalment credit. On top of this, 3 million revolving accounts have been closed between April 2011 and April 2012.

Regulatory evolutions discussed by the French government indicate that:

— Promotion and distribution of revolving loans may become even more difficult for specialized financing companies, especially at the point of sale.
— The implementation of a central consumer credit database is not an option, making credit decision making more difficult.

Stuck between financial and operational consequences of global and national regulations, specialized financing companies are preparing for a new era full of uncertainty as the Golden Age of revolving loans might be coming to a close.

In the coming years as new regulations progressively come into force, ROE’s for retail banks are expected to fall significantly. Handicapped by the unstable regulatory and fiscal environment and challenges from new types of competitors such as payment institutions and new intermediaries that are free from banking restrictions will have a significant impact on French banks. Beyond regulation, banks also need to address the opposing pressures of cost reduction and the need to invest in innovation to cope with the ‘digital disruption’ from the consumer driven digital economy and mobile revolution.

To achieve this we believe that French retail banking players need to focus on delivering both operational and customer excellence. In particular looking at the following key areas:

— Deep restructuring of their organizations - including developing strategies to meet the capital, liquidity and leverage requirements of Basel III and adapting IT strategy, systems and back office processes to address the requirements of SEPA.
— Redefining their product mix – to provide greater consumer choice in an increasingly competitive landscape
— Rethinking how to retain and attract new customers - by offering added value services such as innovative mobile payments services, and extending online banking capabilities.

2013 looks set to be another year of change for the French and global retail banking industry as the regulatory environment becomes clearer and banks crystalize their plans to address the demands of ever fickle consumers looking for better rates and new ways to access products and services.

For more information on how Investance can help your organization to address the changing regulatory and business environment contact

Charles Plessis, cplessis@investance.com
Credit Value Adjustment

An old challenge for the New Year

During the financial crisis a new set of words suddenly entered mainstream discussion. The media, politicians and the general public talked about Derivatives, CDS’s, ABS’s and other esoteric financial instruments that until then were hidden deep inside the lexicon of banks or described in obscure academic papers. Suddenly everyone was interested in understanding the role of these instruments in the crisis.

How was it possible that these complex instruments developed by brightest minds in finance and designed to distribute and manage the risk through advanced financial engineering could have such a massive impact on the real economy. Indeed, banks were able to create and distribute credit so widely that it became almost impossible to understand the exposure in the system.

Derivatives became the scapegoats of the crisis, famously called “financial weapons of mass destruction” by Warren Buffett. Analysts, politicians and commentators pointed at them as the main cause of the huge losses for banks. The interconnectedness of the financial system ensured that the counterparty credit risk was so pervasive that a failure of one large derivatives counterparty could lead to a series of failures globally. The stark reality of this risk was brought to attention following the failure of Lehman Brothers and the near failure of AIG.

Initial analysis of the situation seemed to confirm this hypothesis. In the first document published by the Basel Committee for Banking Supervision in December 2009, titled “Strengthening the resilience of the banking sector”, it was clear that a large part of losses were linked to errors in the estimation of credit and counterparty risks of these particular complex products.

In response, the Basel Committee (Basel III – CRD4) mandated the concept of Credit Value Adjustment (CVA) to be used for capital calculations. CVA aims to take into account an additional charge to cover the risk of loss on derivatives products in case of the counterparty default. This charge is based on the credit quality of the counterparty and is defined as the difference between the value of a riskless portfolio and the value of a portfolio in which counterparty risk exists. In other words, the CVA is the fair market value of the credit risk of the said portfolio. (The calculation of CVA takes into account the Probability of Default (PD), Expected Potential Exposure (EPE) and Loss Given Default (LGD)). The resulting CVA is the fair market value of credit risk.

Measuring the risk of counterparty default is not really a new concept and is a measure that many major OTC Derivative Dealers used before the Basel III mandate. Specifically, they estimated the “fair value” of derivatives using their own accounting approach and compared it to the risk management valuations that measured the risk of counterparty default. The reality was that the standards used to estimate the ‘fair value’ of these products was not sufficiently standardized and methodologies not clear enough.

In today’s environment of heightened attention to counterparty risk, CVA should be applied on all banking and trading books, except where the Derivative trades are cleared through designated central counterparties. The nature and function of the central clearing counterparties are defined in the Dodd Frank Act for the US or by the EMIR Directive for Europe. All derivative trades cleared through these central counterparties are considered as free from the counterparty risk and therefore do not pose systemic risk. Consequently, these types of deals are subject to substantially lower capital charges and escape an additional CVA charge.

To calculate the CVA, two methods are available: standard CVA and advanced CVA. The advanced CVA is linked to the use by the institutions of an internal model for risk calculation and depending of their global exposition to counterparty risk. However if most systemically important financial institutions (SIFIs) use internal models for their risks calculation, they often choose the regulatory standard CVA.

Over the past year banks have spent substantial resources to develop capabilities to measure and integrate CVA into their trading decision making processes. This required the mobilization of various functions within organizations from Quants to IT. However many realized that the challenges around the calculation and use of CVA are greater than simply implementing a mathematical formula.
Looking ahead

Financial services firms, especially large banks that grew through voluntary or “forced” mergers have considerable integration work ahead of them. One of the key areas for improvement is in implementing a comprehensive and pervasive risk culture that integrates the dimension of counterparty risk mixed with market risk. In 2013 we are likely to see banks focusing on core issues and addressing questions such as:

- Managing financial results – how to smooth the volatility?

Since CVA is calculated using risk measurements based on the quality of the counterparty estimated by an internal scoring system or by an external rating by an agency, it has volatility that is outside of bank’s direct control. Measuring counterparty risk therefore introduces additional volatility in the amount of capital required which could have an impact on earnings. Banks must find ways to mitigate counterparty risk as much as possible through innovative ways such as securitizing and selling CVA as well as more traditional methods such as adequate collateralization.

Specifically:

- CVA must be calculated for each level of the group entity consolidation tree. This requires a clear picture of the relationship that each counterparty has with the different legal entities of the bank’s group. The addition of all exposures from one counterparty gives a true CVA picture. To achieve this, banks central compute CVA at the group level and then redistribute the results for each entity into their own contribution to the CVA.

- CVA as a metric is different from many others, it requires risk based and accounting based views since it is essentially a mix of the well-known credit risk and the fair value accounting concepts. Furthermore, CVA requires a strong link between the VaR measuring market risks and counterparty risks. However, since methodologies and information systems are different, CVA can pose challenges to calculate.

- The calculation of CVA is a complex process as it requires powerful computing engines, capable of performing millions of calculations across products and counterparties. The calculation is carried out by Monte Carlo simulations. In addition, CVA calculation requires new data to understand Expected Potential Exposure (EPE) and better quality data controls to manage the vast quantity of data that needs to be sourced and the calculations required.

From CVA to DVA – is this trip worth taking?

Lastly, no discussion on CVA can be complete without addressing its twin – DVA. The European regulators have not decided on whether and how to apply the Debt Value Adjustment (DVA). This concept is discussed in accounting IFRS 13 and has been implemented in the US. According to FASB 159 (adopted in 2007), firms can recognize declines in the market value of their own debt instruments as current earnings. This is particularly relevant for banks that fund themselves in the bond markets. When their credit risk goes up, the value of their debt goes down, creating a somewhat perverse situation when they profit from doing badly. This has introduced a tremendous amount of volatility into the bank earnings over the past 2 years. Jamie Dimon called DVA ‘one of the more ridiculous concepts that’s ever been invented in accounting’.

The Financial Accounting Standards Board in the US is expected to roll back the debt or debit value adjustment provision shortly. One can only hope that European Regulators learn from their peers across Atlantic and do not subject the banks to unnecessary expense and earnings volatility.

For more information on how Investance can advise your organization on the requirements of Basel III please contact

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The impact of Basel III on medium-sized banks

A widely understood regulatory framework

Despite the fact that the implementation timeline is still unclear, the main features of Basel III have been widely reported and are well understood. The key points are:

- Total Capital requirement will rise from 8% to 10.5% including conservation buffer, 8.5% of which must be Tier 1 Capital
- Capital quality will improve thanks to the increasing share of Tier 1 Common Equity (CET 1)
- Leverage will be limited to a maximum of 33 to one of the Tier 1 capital.

If that's not enough, local regulatory authorities may also impose their own rules based on their assessment of the economic environment and the particular country's approach to limiting the risk posed by financial institutions. Overall the rules imposed on financial institutions to guarantee the solvency of banks at both a global and local level are a lot tougher in terms of capital requirements.

A reform which is not only about solvency

Basel III proposes significant changes with regards to new standards for liquidity and large exposures. As with many other regional or global regulations that followed the financial crisis aimed at harmonizing disparate national legislations, the Basel Committee has strengthened the monitoring of liquidity for financial institutions through the introduction of both short term and long term liquidity ratios as key metrics to measure and regulate banks.

The Liquidity Coverage Ratio (LCR) requirements focus on the need to create and maintain a permanent liquidity reserve for banks to cope with an unexpected liquidity crisis. Achieving the required LCR levels is likely to result in financial institutions adding significant investments in the Bonds of highly rated sovereigns (e.g. US Treasuries) to their portfolios. Possibly up to 25 per cent of the outgoing flows to theoretically benefit from their liquidity and stability despite the absence of investment returns. According to information from the European Banking Authority (EBA) the final calibration of the ratio should be known at the end of 2013 along with the definition of assets allowed.

Also focusing on risk mitigation, a cautious approach to the risk weighting of specific asset classes in capital calculations must be taken in response to new risk-weighted asset requirements (RWA) to identify large exposures. As the regulatory statements below from the European Commission’s Capital Requirement Regulation show, this ratio will also generate or require an improvement in the quality of banks’ funds to limit the relative size of exposure.

Article 381: Definition of a large exposure

An institution’s exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its eligible capital.

Article 486: Definition of eligible capital

By 31 December 2013 the Commission shall review and report on the appropriateness of the definition of eligible capital being applied for the purposes of Title IV of Part Two and Part Four and shall submit this report to the European Parliament and the Council, and, if appropriate, a legislative proposal.
The significant effects on return on capital

In meeting Basel III requirements we expect to see a growing mobilization of resources to meet capital and liquidity levels, the consequence of this will be constraints to the development of regulated financial institutions.

The new solvency ratios involve holding two and a half times more capital and double the amount of Tier 1 Common Equity. The LCR is likely to limit profitability by requiring pools of liquidity to be tied up in “safer” Treasury Bonds or similar assets with lower investment returns as well as have a negative impact on equity ratios. Adding insult to injury, the Large Exposure Ratio is likely to cause some headaches to banks that have to limit exposure to the largest counterparties and increase the level and quality of their capital.

The difficulties for medium-sized institutions to prepare for reforms

Our analysis shows that for many banks of average size, the direct and related impacts on the four areas raised (solvency, leverage, liquidity and large exposure) are inversely proportional to their size.

Assuming that the latest iteration of the solvency ratio has a significant impact on the cost of capital, our analysis highlights disparities related to the activity of the institution: for example a deposit-taking institution will be weakened by risk-weighted asset requirements, institutions offering short-term credit will have difficulty in improving its liquidity ratio, and a corporate investment banks will be heavily impacted by the new leverage ratio standards.

We are seeing more medium-sized institutions that are not watched as closely by the market and regulators because of their size, delaying their responses to the impact of these four new requirements. These companies have not developed a strategic roadmap to address issues that will undoubtedly arise. This lack of anticipation can be costly in the medium-term and harmful to the sustainability of the bank activities. In response to this perceived “wait and see” attitude, the regulators have already increased the ratio requirement of some of these entities on an ad hoc basis to effectively add what some describe as an “airbag” to protect them.

We have to assume that besides the new countercyclical “airbags”, the existing ratio targets within Basel III for this type of institutions will be maintained.

The urgent need to build a strategy

The Basel III reform aims to crystallize prudential requirements even if it means limiting the growth of the financial institutions.

Beyond the imposed additional checks or controls on profitability of equity, solutions have to be found to maintain a viable business model. Those solutions can be:

- Analyzing and understanding the regulation to meet the minimum capital standards
- Selling or discontinuing activities which are deemed too unprofitable (for example some investment banking activities)
- Transforming the organization into centers of excellence to deliver superior returns
- Creating new business models that focus on activities that minimize the financial on the organization (for example tightening the risk appetite, increasing credit rates or reallocating customers’ savings to liquidity providers)
- Consider options to avoid the regulatory requirements imposed on banks with entities such as loan financing firms.

If simulations and decisions have already been taken by the larger systemically important financial institutions to deleverage expensive activities in equity (such as private equity and brokerage), it is time medium-size financial institutions to start designing and executing their strategy quickly.

For more information about how Investance can assist you with developing a strategic roadmap to respond to Basel III please contact

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1 LCR addresses the sufficiency of a stock of high quality liquid assets to meet short-term liquidity needs under a specified acute stress scenario.

2 LCR = assets liquid / [outflow - min (inflow; 75% of the outflow)]
Solvency II: Mastering the data challenge

Originally introduced in the early 1970’s, Solvency I was a European harmonization directive that primarily focused on the capital adequacy for insurers. However, Solvency I lacked robust risk management and governance requirements for insurance companies and the rules were inconsistently applied across Europe.

The European directive Solvency II sets out to address some of the shortfalls of the Solvency I regime. Its main objective is to strengthen risk management practices of insurance companies as well as enhance transparency and disclosure with stricter reporting standards. Solvency II sees regulators impose strict data quality requirements by providing a standard framework. The regulation requires market participants to not only conduct insurance risk modelling but also implement greater controls and provide full traceability of information, systems and processes used to produce this information.

The directive is composed of three pillars:

**Pillar 1**
Qualitative and quantitative requirements for calculation of Solvency Capital Requirement (SCR) and Minimum Capital Requirement (MCR).

**Pillar 2**
Governance and risk management and documentation including Own Risk and Solvency Assessment (ORSA), Risk Management System, Policy processes and procedures and key functions such as compliance, risk, audit and outsourcing.

**Pillar 3**
Supervisory reporting and public disclosure to encourage transparency by providing two types of report: Solvency and Financial Condition Report (SFCR) and Regular Supervisory Report (RSR).

A work in progress

The work carried out by insurers has so far been focused on the quantitative aspects of the reform (Pillar I) and in particular on the development of modelling tools. The results of the fifth impact study (QI55) revealed increasing engagement of market players but reported varying quality of the data transmitted.

Despite the insistence of regulators for insurers to adhere to reporting standards by June 2012, nearly 80 per cent of European players reported that they had not adapted their processes to Solvency II reporting requirements.

The continual delays in the implementation of the Directive has been seen by insurers as an opportunity to strengthen their investment on major projects to deliver the reporting and disclosure requirements of the regulator. The ability of the insurance industry to comply with by Solvency II comes down to the quality of data and the processes in place to collate, analyse and report on it.

Solvency II reporting is divided into two categories:

- **The descriptive:** covered by Regular Supervisory Report (RSR) and Solvency and Financial Condition Report (SFCR)
- **The quantitative:** covered by Quantitative Reporting Templates (QRT).

For the European Insurance and Occupational Pensions Authority (EIOPA), the information contained in the QRT is essential for an insurer looking to establish a greater control over risk. This data should therefore already be available or provisioned by companies in their preparations for Solvency II.

In fact, the number of insurance organisations making progress has improved a great deal. There are so far 67 companies who have completed QRTs, however the level of detail required is very high and meeting the requirements for many insurers will be long and difficult.

Looking ahead there are also some strict deadlines for delivery of reports on an annual and quarterly basis. Of course organizations produce a number of regulatory reports and financial communication for various stakeholders already. However, the production of the information required in the main is less industrialized with data usually collated at the end of quantitative process.

New quality requirements and tough deadlines imposed by the Directive will require a global production of information that will require insurers to upgrade their processes to avoid impacts on the delivery.
The data management paradox

The collation, manipulation and control of every aspect of data is core to an Insurer’s business. It drives the pricing of products, management of claims, customer relationship management, customer service and taxation. However, recent studies highlight how insurance firms have struggled to put in place proper data quality standards to comply with Solvency II.

Indeed, insurance firms faced with the coexistence of various IT systems covering back office administration, from different subsidiaries and covering a range of product offerings across business lines are managing a vast amount of data from a number of sources. The variety is mainly due to the setup of each business line and needs to take into consideration the assortment platforms used for managing product portfolios, and disparate systems inherited through mergers and acquisitions.

The challenge is compounded further for Insurers that have already started to implement some decision support systems prior to Solvency II; the new requirements around data quality and management imposed by the Directive could create new challenges for the governance of data that make those systems redundant. The impacts go further to include partner organisations and suppliers such as managed service providers, asset managers and reinsurance providers.

Our belief is that the requirement for robust data governance under Solvency II is a major project that should be conducted with the same vigilance used to create models for Pillar 1.

It is therefore vital that the approach is carefully managed to consider both the constraints in collating the data and the business information systems required to construct a comprehensive framework that will meet the requirements of the regulator at the same time as transform the business for the long-term.

The reach of Solvency II goes beyond the insurance industry; the data reporting requirements mandated under the directive impacts the Asset Management and Asset Serving sectors that supply data to insurers.

Read our article on “The impact of Solvency II on the Data Management value chain in the Asset Management and Asset Services industries” for comment and analysis, see page 40.

Additionally to help our clients address the need for a robust Data Governance framework Investance has published a paper on “Achieving business value through robust data governance” you can read a summary on page 48 of The Year Ahead 2013.

For more information on how Investance can assist your organisation to prepare for the impacts of Solvency II please contact

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Regulation in action: A year of significant progress in FATCA compliance

In March 2010, the Foreign Account Tax Compliance Act (“FATCA”) was enacted to detect and prevent US Persons from evading taxes by hiding behind offshore accounts. In February 2012, the U.S. Treasury published a comprehensive draft that helped clarify most grey areas in the regulation. Subsequently, the Treasury in conjunction with partner countries published two model intergovernmental agreements (“IGA”) that set the framework for FATCA implementation. This approach attempts to address industry concerns regarding privacy laws in local jurisdictions that pose a compliance challenge to Foreign Financial Institutions (FFIs). Models I & II of the IGAs have key differences forcing global banks to vary their implementation approach based on the model adopted by the local taxing authority.

In response, affected entities have undertaken internal assessments of client on-boarding operations and underlying technology to measure their ability to determine and report the tax status of each account. Financial Institutions must also focus on augmenting their KYC and AML processes while extending their account opening systems capabilities. Similar efforts are to follow for tax withholding and end of year reporting processing both in operations and technology.

A comprehensive plan must be put in place early in the process to communicate the impact of the regulation to clients and avoid any adverse effects on the overall client experience.

Although widely expected by the end of the summer 2012, the final version of the regulation has yet to be issued as of the end of November 2012. Updates to the regulation issued by the U.S. Treasury have delayed some implementation dates to allow affected entities time to respond and align with the dates proposed in the IGA models. The graph below shows the regulation timeline with key milestones highlighted for emphasis.

January 1, 2014 is the new effective date for new account opening procedures. The FATCA withholding date for fixed, determinable, annual, or periodic (FDAP) income remains January 1, 2014. However, the effective date for withholding on gross proceeds was moved to January 1, 2017 and coincides with the effective date for withholding on pass-through payments. It is worth noting that three key activities (account opening, due diligence & reporting, FDAP withholding) have due dates in 2014.

Financial Institutions must prioritize their FATCA response initiatives in 2013 and establish the governance necessary to address key early requirements including existing account due diligence and reporting, new account opening procedures, client communication and FFI registration or compliance with the requirements in their jurisdiction.
FATCA Timeline and key milestones

Key elements for FATCA Compliance

On January 1, 2013 financial institutions can begin the registration process either online with the IRS or locally depending on the IGA model adopted. The two models however, present differences that impact the implementation plans of global entities. A few key differences include:

- Model II defines “non-consenting US account” holder. This concept does not exist in Model I
- FFIs under Model I will generally not be required to withhold for recalcitrant accounts. Under model II, an account can be treated as a recalcitrant and be subject to withholding
- Model I provides that FFIs report to their taxing authority who report to the IRS. Under model II, the FFIs are required to report certain information directly to the IRS
- Model I provides for reciprocity in reporting between the US and partner country. Under Model II, there is no reciprocity rather the US may negotiate a reciprocity arrangement if confidentiality standards at the partner country are met
- In model I, FFIs have to comply with the registration requirements in their jurisdiction. Model II requires that FFIs in partner countries comply with the requirements in the FFI agreement

The regulation places renewed attention to entity ownership and controlling interest by US Persons. Pre-FATCA KYC and AML processes are motivated by the need to identify activities that may be funding terrorism and support proactive risk management by subjecting certain accounts to frequent reviews. FATCA driven KYC requirements set a threshold of 10% ownership in an entity and define a new set of metrics for account evaluation during on-boarding. Any change to the account that introduces US indicia, triggers a review and request for additional information.

Current infrastructure for payment processing poses operational and technology challenges as it is mostly aligned with specific business lines. FATCA requires a holistic view of account activity across the entire bank forcing entities to determine how systems and operations should be harmonized to share information.
Activities to prepare must include the following priorities

The regulation affects all aspects of the organization and requires project governance with participation from compliance, finance, front office, operations and technology. Equally significant is the implementation of a plan to communicate to clients all key activities and rollout strategy. This is critical in helping set expectations and minimizes any negative effect on the client experience.

Entities must have efforts under way or organize and mobilize one immediately to address existing account processes and systems, and gain a thorough understanding of the completeness of account information. Client master and account tracking systems must be evaluated against FATCA account reporting requirements. Technology organizations should be working on extending their on-boarding systems to capture and store the additional client profile information and documentation required. Operations must review and augment the KYC processes and controls to the metrics dictated by FATCA guided by the applicable IGA model and requirements of the local jurisdiction.

Looking forward

The recent financial crisis has forced governments around the world to place renewed emphasis on finding sources of revenue. Tax related topics have been in the forefront of that discussion as evidenced by the French Government proposal to tax financial transactions, the German Government’s offer of tax amnesty to Germans with offshore accounts, and increased pressure on the Swiss government for more regulation on accounts in Swiss banks.

Affected entities would be prudent to closely monitor such developments around the world. Financial entities must include monitoring of FATCA negotiations between the US Treasury and local Taxing authorities to understand the rules under consideration, advocate in their favour and be proactive in their response.

Internally, response teams must put in place proper governance to address immediate priorities around client due diligence and reporting. New account requirements, strategy for client communication. Planning should also be under way to assess System Tax Withholding capabilities for FATCA and extensions to end of year reporting for clients and taxing authorities. The impact of FATCA on tax withholding for gross proceeds and foreign pass-through payment does not come into effect until January 2017 however, it materially impacts current processes and systems, and requires long planning and implementation cycles.

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The changing European payments landscape: What will and must be changed?

The Single Euro Payments Area (SEPA), originally conceived as a market-driven project, is now regarded as an essential element to advance the usability and maturity of the Euro. However, the slow migration from national payment instruments to EU-wide instruments (as of May 2012 only 28.2 per cent of credit transfers and 0.034 per cent of direct debits within Europe are executed in accordance with SEPA standards) has led the European Central Bank to consider it necessary for a legally binding end-date to be established.

Consequently, national-designation schemes will be abolished by the 1st of February 2014, providing uniform access to the new payment instruments. This means that as of this date, existing national euro credit transfer and direct debit schemes will be replaced by SEPA Credit Transfers (SCT) and SEPA Direct Debits (SDD). In non-euro countries, the deadline will be 31 October 2016.

<table>
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<tr>
<th>Date</th>
<th>Description</th>
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<tr>
<td>1 February 2014</td>
<td>SEPA migration deadline for SEPA credit transfers and SEPA direct debits within the euro area; no Business Identifier Code (BIC) to be required for national payments.</td>
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<tr>
<td>1 February 2016</td>
<td>No BIC to be required for cross-border payments; niche products migration complete.</td>
</tr>
<tr>
<td>31 October 2016</td>
<td>SEPA credit transfer and SEPA direct debit deadline for non-euro area countries.</td>
</tr>
<tr>
<td>1 February 2017</td>
<td>National transaction MIFs (multilateral interchange fees) to be eliminated for direct debits.</td>
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SEPA will impact virtually all forms of payment services (payment operations, payment infrastructures, payment systems, rights and obligations in relation to payments). This means not only payment service providers, but also payment service users (PSUs) such as corporates, small and medium sized enterprises, public administrations and government agencies.

The EU Commission originally predicted a massive financial benefit to the business sector, in the range of €50bn–€100bn. It saw much of this benefit coming in the form of a transfer from the bottom line of the banking industry into savings for bank customers, businesses and the public sector.

However, many commentators challenge the basis of the calculation of this saving, and suggest much lower benefits.

The key drivers of these savings are:

1. Improving the efficiency of cross-border payments and turning fragmented national markets for Euro payments into a single domestic one. SEPA will enable customers to make cashless Euro payments to anyone located anywhere in the area using a single bank account and a single set of payment instruments.

2. Developing common financial instruments, standards, procedures, and infrastructure to enable economies of scale. This should, in turn, reduce the overall cost to the European economy of moving capital around the region (estimated as two to three per cent of total GDP).
Increasing surveillance of electronic money flow, particularly regarding money laundering (monitoring of illegal business, organized crime and tax evasion)

Migration to SEPA schemes and technical standards is beneficial but requires careful planning. For example, European banks will have to override the technical and cultural barriers of the European payments systems, protect their margins and balance sheet and also be forced to discard technology solutions which in some cases were implemented very recently.

Banks have to look for ways to meet the European Public authorities’ requirements at the same time as working towards European integration whilst managing a complex technical and commercial strategy and staying focuses on the commercial logic for investment to ensure development and permanent modernization.

Moreover, how to control costs and hit deadlines? How to define the new competitive strategy and find new demand in order to justify the “business case” for investment at the same time as constantly improving the service provided to existing customers and implementing new management solutions?

Who will be the new players? What opportunities and challenges will such a significant step-change create?

It is obviously a technical challenge, but also an economic one, with a new model to handle, a new business case and marketing strategy to build. It is also a new stage for IT systems, which will need to be consolidated resulting in the disappearance of some and growth beyond borders for others.

This is also challenge for bank customers, and a priority for businesses and services: What will the new service look like? What will be the role of the different payment instruments? How will the SDD impact banking terms and conditions?

In payments, all changes impact a range of technical systems: servers, software, terminals, cards and networks. This will lead to tight deadlines, control of technical risks and can impact the quality of service.

The adoption of SEPA payments processes and functionality has proved to be a daunting task so far. Tough economic constraints and a rapidly changing banking landscape have not helped. An interesting result of the impact shows that it is the medium sized companies from 1,000 to 10,000 employees that have struggled the most to adopt SEPA payments formats and services, whereas, smaller and larger companies are more advanced in the adoption.

Looking ahead we can foresee a busy second half of 2013 for banks. The back office operations of banks fear they will be deluged with requests as the 1st January 2014 deadline approaches. Time is short but with a strategic approach with experienced vendors and developers expected to play a key role, the challenge is not insurmountable.

For more information about SEPA or to discuss how Investance can assist your organization to prepare please contact

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Part 2:
Expertise applied. Value added.

Sharing practical insights and expertise to help Financial Services companies respond to regulation
Next generation outsourcing: New opportunities for financial organisations

Tough economic conditions, increasing regulatory obligations and global competition are adding to the significant pressures on financial institutions to reduce their operating costs. Over the past 10 years many organizations have been lowering fixed costs by outsourcing and/or off-shoring some of their utility functions. Services such as IT support and development, call centers, and ‘transaction intensive’ operational processes have been outsourced to large Business Process Outsourcing firms such as IBM, Wipro, Cognizant and Infosys.

Today the same firms are rethinking their front-to-back business model in order to achieve further cost efficiencies with lasting impact. In an effort to manage core services, they have engaged with business process outsourcers to run their activities in a more professional and effective manner. We have also seen the emergence of shared service centers offering to bundle administrative services across products and regions. These processes can be standardized and automated in order to achieve higher proficiency levels through economies of scale. Such evolution is increasingly a key facet of ongoing success and organisations are looking to implement flexible business models with a rethink of how fixed costs are managed.

However, the new wave of outsourcing is emerging focusing on “economies of skills” vs. “economies of scale”. As the competitive landscape drives firms to find new ways to reduce cost, the natural progression is to identify outsourcing opportunities with specialized skills in areas such as risk management, client servicing, financial product support and other high end functions. Outsourcing of these types of functions across all departments is increasingly proving to be key element of the strategy to ensure that business lines and profitable client relationships are maintained whilst achieving cost reduction targets.

Pursuing “economies of skill” will require that financial services firms have assurances that their BPO partners have the right capabilities to support them. In particular, they need to consider the business and delivery model, location strategy and implementation framework to deliver results.

Business and Delivery Model Considerations

Initially many financial firms have chosen to use a captive model which involves moving parts of their operations to a site which they own in the lower cost location. Often this approach facilitates faster implementation for reasons of control and culture since staff consists of direct employees. With the increased focus on fixed versus variable costs, many firms who are now looking to outsource to a third party. These efforts can involve outsourcing to an established service provider or a spin-off of the captive centers into separate entities. A good example of this can be the 2008 deal where TCS acquired Citigroup Global Services and signed a large contract to provide outsourcing services to Citi for the next nine-and-a-half years.

A main challenge with these projects is segregating the business which is appropriate to outsource versus running it in a captive offshore center. In many cases roles have been transitioned to offshore locations without being completely standardised. Many of those roles still require a degree of flexibility and control which will not be possible after a handover to a third party vendor. As a result it is clear that significant investment is required to prepare for outsourcing and to implement changes in a controlled manner. However this approach provides opportunities to optimise the balance of fixed and variable costs, improve the efficiency of balance sheet usage and cash flow, whilst supporting industry capital adequacy targets. In addition firms can capitalise upon a fresh perspective and depth of experience and technology of the growing range of specialist providers in the industry.

While large scale outsourcing may be appropriate for large financial services firms like Citi, some smaller firms may not have sufficient scale to gain the desired result from outsourcing their own offshore activities. A new trend is emerging where two or more competitors pool their offshore service centers into a “Shared Service Centers” that operate as separate legal entities from parent companies and provide services to them.
This is a promising trend as it allows such Shared Service Centers to achieve required scale while allowing the parent entities to move from fixed to more variable costs associated with third party contracts.

Choosing the right location

Identifying the most appropriate locations and then obtaining access to low cost, flexible yet highly specialised expertise is becoming a key differentiator for firms’ ability to service their clients effectively. Location selections are based on many factors that must be thoroughly considered:

1. Time zone – does the location need to be in the same time zone as the onshore location? Is the new location part of a 'follow-the-sun' model? Many firms are blending operations in both nearshore and farshore locations in order to service their clients in appropriate time zones with a 24 hour per day availability.

2. Language – Do some of the functions that are planned to be outsourced require a certain level of language skills? Beyond language skills, some functions may require familiarity with cultural norms of the parent company’s country.

3. Proximity to hubs – Is proximity to the firm’s regional hubs important for training and management oversight and control?

4. Labor market – Does the labor market have the required level of liquidity of appropriate level and skill resources?

5. Competition – Are there any other peer financial services firms in this location? If yes, there could be trained resources available, alleviating the need to train new hires. However, financial services firms in these types of locations are likely to see higher attrition rates.

6. BCM – Are multiple locations required for business continuity management and resiliency?

7. Scale – What is the intended size of the location and how many resources are required to achieve critical mass?

For many BPO projects, roles are migrated initially to a nearshore location in order to enable closer control over process reengineering activities. While already realising some cost benefits, preparations can be made gradually before migration to farshore locations and third party vendors to maximise cost efficiencies. Nearshore locations are a good testing ground to determine if functions can be completed outside of hub location. A ‘conveyor belt’ process can be established, which functions moving farshore once successfully trailed nearshore.

However, we have seen that dividing work across locations can introduce complexity and risk to business processes so advanced workflow and collaboration platforms are required. Given the global emphasis on regulating the industry, with the potential to move both front and back office functions off-shore, the regulatory framework in the target location is likely to become an increasingly important factor to smooth the transition.

Implementation framework

It is clear that financial organisations are now outsourcing more complex functions, including those which are client facing, in order to address cost pressures. The industry has moved beyond business process outsourcing of standardised roles and back office functions to Knowledge Process Outsourcing (KPO) involving key parts of the service delivery value chain. Beyond the original focus on IT and operations, finance, risk and some front office roles can also be within scope. The availability of analytical and technical skills in farshore locations is constantly increasing.

However, a challenge rises on the way to implement the KPO services and what vendors are able to support them. Any organization attempting to initiate KPO should define an appropriate model and ensure that the outsourcing provider is able to operate under the required framework.
Knowledge Process Outsourcing Framework

**Utility**
- Developed as a response to common requirements across product lines.
- Leverage synergies across identical processes.
- Maintain regional structure for exception management and complex products.

**Centres of Excellence**
- Consolidation of subject matter experience.
- Transferred autonomy, control and accountability.
- "Value-Add" activities.
- Leverage synergies through integrated systems.

**Factory**
- Core processing activities.
- Strong economies of scale.
- Greatest cost savings.
- Access to large and flexible resource pools.
- Facilitate the creation of global operations utilities.
- Provide robust PCM.

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**Regional Siloed Hub**
- Centralised with a time-zone.
- Product siloed.
- Basic understanding of local markets and customers.
- Mitigate language and cultural barriers.

**Load Balancing**
- Multiple processing centres using common tools and processes.
- People and premises protection for business continuity management.
- Example: Equities reconciliations carried out in three hubs but using a common platform.

**Co-located Silos**
- One centre supporting multiple trading centres.
- Regional or product silos are maintained.
- Example: A recs team siloed by product using different systems and supporting different time-zones from one location.
Furthermore, in defining the framework to implement KPO services, substantial consideration must be given to the overall integration of such services with those retained in-house. From the customer perspective, the organization must operate in a seamless fashion without exposing the presence of third parties in parts of the value chain.

**Spotlight on Knowledge Process Outsourcing in India**

Outsourcing of knowledge services to India has witnessed tremendous growth over the last decade. A report on the KPO sector in India by the Associated Chambers of Commerce and Industry of India (ASSOCHAM) highlights that earnings from the KPO industry in India was $8 billion in 2011 and is expected to grow at a rate of 25-27% in 2012.

The country possesses a large number of specialized domain experts such as engineers, CAs, lawyers, architects, biotechnologists, economists, statisticians and MBAs. Tapping into this talent pool allows overseas companies to gain superior quality services at cost-effective prices.

Despite increasingly tough competition from Russia, China, Latin American, Eastern European and some Asia Pacific countries the Indian KPO market is expected to continue growing at a rate of 20% annually and retain its dominant position in near future.

In addition, the government of India also recognizes the potential of KPO business in India and has taken measures to promote the growth of KPO in India and there is an established Information Technology Enabled Services (ITES) sector and infrastructure to support the delivery of services to overseas firms.

Financial research, including equity and credit research is one of the most dominant services that KPO firms provide and India is fast becoming the financial research hub of the world due to availability of skilled professionals offering services in various domains including financial research, business and market research, legal services, data analytics, consulting as well as medical and legal research. According to a NASSCOM-CRISIL study, financial services would continue to be the largest contributor to the growth of the knowledge services outsourcing industry in India.

Looking forward with an ever increasing pool of highly skilled people available at competitive cost, increasing outside investment in the country, financial sector regulatory alignment and a growing economy forecast to reach $5 trillion by 2020 the strength of India as a leader in knowledge services outsourcing looks secure.

Through 2013 and beyond a raft of regulatory deadlines will be reached which will put pressure on the new business models being implemented by financial institution’s to increase efficiency and reduce cost. We expect to see a continuing drive to explore new possibilities to streamline operations using a combination of on-shore managed services, off-shore KPO and BPO services where having a robust approach to location strategy, and implementation will become increasingly important.

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The impact of Solvency II on the Data Management value chain

Focus on the Asset Management and Asset Services industries

Not an “Insurance only” issue

The implementation deadline for Solvency II – the regulation that establishes a Capital and Risk Management Regulatory Framework for European Insurers – has proved a moveable feast in recent years. If the regulators accept the two year extension proposed by the European Insurance and Occupational Pension Authority (EIOPA) at the end of November 2012, exactly when the industry will need to comply with the new standards will remain uncertain.

However, preparation is key and Data Management is one of the most critical areas of focus for institutions impacted by Solvency II. The European Fund and Asset Management Association (EFAMA), noted that “Solvency II should not be viewed as an “insurance-only issue” as Data provided to insurers from third parties, including Asset Managers, will also be held to the same strict quality standards”.

Asset Managers and Asset Servicers (Custodians, Funds Administrators and other service providers) will have to demonstrate best practices in Data Management more than ever. We believe that the process of mastering Data Management to comply with Solvency II can be an opportunity for Asset Managers and Asset Servicers to reinforce their relationship with their insurance clients.

However, some other Asset Managers or Asset Services firms may consider the new Solvency II requirements as a threat to their business with Insurers, as they create new barriers to entry. Of particular note is the additional investment and recurrent costs required to upgrade Data Management.

As a consequence, how individual Asset Managers and Asset Servicing firms develop and position their services for Insurers is likely to change significantly: it does not only impact Europe, given that Solvency II has extra-territorial reach (as for example an American or Asian Asset Managers managing dedicated securities portfolio for a European Insurer will also be impacted by Solvency II requirements).

Data Management: A far-reaching topic

Although Asset Managers are selected by insurance companies on their ability to manage assets and achieve returns, now they must focus on Data Management as one of their core capabilities.

Indeed, Data Management activities include Data Acquisition (for example: all processes related to relationship with Market Data Providers – such as Bloomberg Datalicense, Reuters Datascope, Telekurs), the management of Reference Data and Data Distribution. An important point to note is that the data can be acquired or be produced inside their organization (for example: the mark-to-model valuation of a complex OTC financial product might be developed internally using elementary Market Data stored internally for distribution to end users).

It should be noted that Data Management has been a focus area for asset managers for some time. Quality data is needed to make appropriate investment and trading decisions. However, with Solvency II, Data Management is crossing organizational borders and is likely tie together asset managers with their insurance clients. While requirements stated under Pillar 3 of Solvency II are likely to have the greatest impact on most Asset Managers and Asset Servicers, it must not be forgotten that the other Pillars, and in particular Pillar 1, also generate new Data Management needs.

Major impact of Pillar 1, which provides the quantitative rules for Solvency Capital Requirements (SCR) and Minimum Capital Requirements (MCR) calculations lies in how the investment processes will be reorganized between Insurers and Asset Managers.

The need for an Asset and Liability Management (ALM) based investment process as well as the necessity to anticipate results of investment decisions on the SCR and MCR will lead to reviews of the types of information shared between Insurers and their Asset Managers, in particular the “ex-ante” (i.e. before Investment decision is taken) information. One should keep in mind that among this “ex-ante” information there are investment guidelines, which constitute a particular category of reference data to be stored and managed in the information system of Asset Management firms. In addition, for the assets and portfolios that remain directly managed inside the insurance company, they will have to directly rely on their Asset Services provider(s) to get information needed to comply with Pillar 1.
The impact of Pillar 3

Pillar 3 substantially increases transparency and imposes new reporting obligations for Insurers. Asset Managers and Asset Servicers are directly impacted by these requirements since they supply the information that Insurers need to meet Pillar 3 mandates. In particular three key areas will be impacted:

1. The need to implement a standardized format (XBRL) for information exchanges between various parties;
2. The need to ensure availability of accurate and traceable (i.e. through appropriate Audit Trail) data;
3. The general application of the “Look through Concept” for all UCITS-based investments. This concept determines that detailed risk factors should be available for each individual investment line in the portfolios. This is a challenging requirement for Funds of Funds but also concerns all other categories of UCITS.

As a result, evaluating the impacts of Solvency II on Data Management needs a global vision of the information flows in the Asset Servicing, Asset Management, and Insurer value chain. This information is also important to comply with Pillar 2 requirements relating to documentation, risk management and governance.

A wake up call for all stakeholders in the Data Management process

Amongst the raft of regulations impacting the Asset Management industry (MiFiD 2, FATCA, AIFMD, etc.) it is clear that Solvency II is the one that impacts the Data Management processes the most. The stakes are high since insurers’ assets under management represented €7.3 trillion for EFAMA Asset Managers at end of year 2010. In addition, the assets of insurance companies represent between 25% per cent and 60 per cent of assets under management by each of the three main French Asset Managers (AMUNDI, BNP Paribas Investment Partners, AXA Investment Managers).

In addition to posing challenges to Asset Managers and Asset Servicers individually, Solvency II also requires clear differentiation and assignment of responsibilities for various sub-components of the Data Management process. This adds complexity to decisions related to IT projects related to Solvency II.

A key issue here is client reporting. There has always been a complex relationship between Asset Managers and Asset Servicers: with each challenging who provides the value in the reporting process and how it will be priced to the final clients.

The introduction of Solvency II brings new and additional challenges in this area.

It is unclear which party will benefit most from opportunities brought by Solvency II. However we can pinpoint multiple ways that Data Management has played a part in clarifying the point of difference:

— Data Acquisition: Organizations that have excelled in their relationships with external Market Data Providers will have a competitive advantage. Achieving this requires effective controls over the Data Acquisition budgets and Service Level Agreements that stem from a strong centralized Market Data purchasing function;
— Data Storage: Asset Managers who intend to provide a full range of Solvency II services to their insurance sector clients will have to establish and leverage “intelligent” Reference Data (i.e. Datamarts) to enable the multi-criteria analysis to support Pillar 3 required reporting as well as information for monitoring of risks exposures in portfolios,
— Data Flow Management and Distribution: Insurers complying with Pillar 2 have the potential to differentiate the services offered to clients
— Excellence in Data Management is a key to supporting clients’ needs to comply with Solvency II. However, the investment needed to strengthen the Data Management processes can be substantial. One may think that competitive advantage will go to those organizations that have critical mass and are able to back this level of investment. However, the market remains relatively open at this stage, and Solvency II may have the effect of reshaping the marketplace through alliances and mergers between those who serve insurance investors.

In evaluating their strategic options, Asset Managers and Asset Servicers should rely on the attention that the European Insurance and Occupational Pension Authority (EIOPA) pays to the complexity of implementing Solvency II. For example the EIOPA is working, to provide detailed guidelines for the application of the “Look through Concept”; and to standardize the risk information in UCITS. Last, but not least, implementation timeline uncertainty will remain if the European Commission agrees with the recent EIOPA proposal (November 22, 2012) to defer the Solvency II implementation deadline from January 1st 2014 to January 1st 2016. Will this open the doors for late-comers to enter the game?

For more information on how Investance can assist your organization to develop data management strategies to address the impact of Solvency II please contact

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*XBRL: Extended Business Reporting Language

UCITS: Undertakings for Collective Investment in Transferable Securities (i.e. Investment Funds registered in the European Union, in accordance with UCITS regulation)
Risk, Finance and Compliance Data Integration: Achieving long promised benefits

Integrating the Risk, Finance and Compliance infrastructure has been on the agenda for Financial Services institutions for a long time. As Chart 1 illustrates, overlaps in the data requirements are substantial, leading many industry analysts to develop business cases that demonstrate the long term benefits of integrating technology platforms, data acquisition methods and operational support functions.

However, one could argue that despite the US $ billions invested in major initiatives, the industry and especially its largest players are not much closer to achieving the desired results. A siloed approach to data acquisition, management and reporting has made the goal of achieving true integration difficult, if not impossible. Current data infrastructures and dependencies have resulted in significant issues around the consistency of data for risk, finance and compliance managers at many of the largest banks and insurance companies.

With Dodd-Frank, Basel III, Solvency II and other regulatory mandates, industry and national regulators are demanding a better insight into what’s going on just below the surface of the bank or insurance company. On the other hand, shareholders’ and the market’s trust in the Financial Services industry has not been fully restored and they demand transparency into the risk adjusted performance of banks. For example, the recent report to Financial Stability Board by the Enhanced Disclosure Task Force has confirmed the need for transparency in terms of disclosures.

In light of the factors mentioned above a renewed push to achieve a true integration between Risk, Finance and Compliance is required. To make this effective, the cost and effort involved in integration can be significant. However, the cost of doing nothing in the long-run can outweigh the cost of this effort as the ongoing costs of maintaining separate data siloes will become prohibitive in an environment where business margins are shrinking.

The success of the Dodd-Frank, Basel III, MiFID/EMIR, Solvency II and FATCA initiatives will depend heavily on the outcome of the efforts to rationalize data sourcing, implement consistent data standards and the convergence of Risk, Finance and Compliance technology platforms. Ultimately, the quality, consistency and timeliness of the data underpinning the control functions will be critical in delivering relevant information to the business, regulators and shareholders.

The essence of the rationalization effort will have to focus on implementation of an unified enterprise-wide data platform, with common services and applications. Whether developed in-house or purchased from the leading vendors, financial services organizations must define a high level data architecture (see chart 2 below for an example) and develop concrete road maps on how to achieve the desired state.
Regulatory Reporting
Periodic and ad-hoc reporting to the national and local regulatory agencies.

**Advantages:** Consistent and transparent information ensures long term trust from regulators.

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**Economic Capital**
The amount of capital that a firm believes is needed to support its business activities or set of risks.

**Advantages:** Allows for more accurate assessment of support decisions about what business lines or transactions to pursue.

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**Cost Efficiency**
Achieving cost savings across all of finance operations by moving to unified ERP, data standards and offshoring of selected functions

**Advantages:** Improved bottom-line

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**Enterprise Risk Management**
The ability to measure risk in a consistent manner across different entities and geographies and develop a consistent enterprise risk management framework

**Advantages:** Better decision making due to a unified view of all the risk factors that affect the organization.

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**Common Information Standards**
The identification of common data elements that are essential for unified reporting across the organization.

**Advantages:** Improved reporting, decision making, and analysis across all business units that share common data.

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**Data Quality**
The ability to leverage consistent and integrated sources of data across the enterprise

**Advantages:** Improved reporting, decision making, and analysis across all business units that have superior data quality

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**Risk & Finance Tech. Integration**
Adoption of an evolutionary approach to achieve synergies across Risk & Finance Architecture

**Advantages:** Allows an organization to gain efficiencies through sharing of common data, tools, infrastructure and utilities

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**Decision Support Architecture**
The identification and measurement of key metrics that will enhance the process of decision making.

**Advantages:** Fast and educated decision making allows an organization to quickly take advantage of any business opportunities.

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**Credit Portfolio Management**
Ability to select the appropriate framework to classify and standardize credit risk measurement across the organization.

**Advantages:** Having a complete understanding of the alternative approaches to credit risk measurement and portfolio management improves decision making.

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**Chart 1:** The data overlaps between Compliance, Risk, and Finance
How to deliver

Experience suggests an evolutionary approach towards architecture integration should be adopted to ensure long term success. This approach must closely match an institution's evolving capability to deliver on complex initiatives. Indeed, very often organizations decide to tackle all the data integration challenges at the same time, resulting in significant delays, changes in scope, long time to market and technical obsolescence even before the integrated data platform can be implemented.

Instead of the "Big Bang" approach, we believe organizations should define a roadmap that is based on developing foundational capabilities and buildings upon them to achieve benefits (see chart 3). This approach will ensure that by the time an organization tries to tackle most complex issues, such as development of common transaction repositories or common pricing and risk measurement methodologies, it will have already implemented key underlying capabilities to ensure shorter time to delivery.
There are several factors that are likely to make a transition to the integrated Risk, Finance and Compliance infrastructure easier:

- Advances in technology have removed many of the latency, bandwidth and storage concerns, allowing more straightforward and lower cost integration. Furthermore, many leading vendor solutions provide a comprehensive set of tools for data integration.

- Industry data standards, originally focused on facilitating Front to Back straight-through-processing, are maturing into information exchange protocols that can be leveraged by multiple parties to exchange data in a consistent fashion. External regulatory bodies have made progress in designing key data standards with inputs from all market participants.

- Many of the leading financial services firms launched data governance initiatives, identified data champions and created teams dedicated to data quality and consistency. Substantial progress has been made in elevating the status of data to the status of ‘corporate asset’.

However, despite these advances, only long-term concerted efforts to achieve a true integration will lead to the results and deliver benefits. Under pressure from the regulators and shareholders, senior management must maintain their focus on this goal and allocate appropriate resources to ensure success.

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Finding the keys to success: Establishing a mature reconciliation and control framework

The financial downturn has thrown the notion of “business as usual” for controls and reconciliations out of the window. Organizations must be prepared to act swiftly and decisively to address sizable near-term cost pressures while ensuring the completeness of controls with fewer resources. Simultaneously, firms must be ready to act boldly and seize opportunities that have the potential to deliver advantages for the long-term.

Some companies are doing precisely this. For example, one of the leading Universal Banks has embarked on a fundamental transformation of its Reconciliation Utility function, which it calls “50/50/50.” The aim is to reduce costs of control by 50 per cent, improve time to solve exceptions by 50 per cent, and improve the return on its investments by 50 per cent. Clearly, this is an ambitious target, but one that if realized, will make its control framework much more agile and better able to implement the company’s fast-changing strategic agenda.

For most organizations who would like to reduce the cost of their control processes, two key questions remain:

1. What are the bold moves that they can take to realize cost savings in the short-term and
2. How can they create a more agile control function for the medium-long term?

Reducing cost of controls through innovation

Most Control cost reduction exercises have focused on “finding the next 10 to 15 per cent.” However, we are now seeing more and more radical moves from organizations, including targeted cost reductions of 40 to 50 per cent, driven by a fundamental restructuring of many players. Universal Banks are at the forefront of these efforts; other smaller players will soon follow.

Like previous recessions, today’s downturn will lead to a significant reduction in costs. While innovation is one way to optimize processes and reduce costs, controls and reconciliations are rarely in scope. Many organizations still rely on legacy processes, and a common error is to try to reduce operating costs by simply moving the poorly managed controls to a low cost location.

We believe that organizations that are able to rethink their control processes and innovate by putting in place a structured, proactive control framework will be able to deliver significant savings. For example, rethinking control coverage to move from a point-to-point approach, to an intraday front-to-downstream approach or by setting up a detection pattern to allow upfront detection of breaks or poor data quality will payoff in the medium to long term.

Of course, technology partners and reconciliation vendors will play a major role in delivering these approaches however finding key accelerators in internal management, validation and consistency of the data to be reconciled is a key part of building a successful control framework.

Securing the talent for the next generation of Reconciliation Centers of Excellence

The pressure to reduce head count will inevitably see a churn in the market for talent. We expect to see the movement of high-performing professionals, either because they are directly affected or because they are looking for new opportunities and challenges. It is this talent that most reconciliation and control centers of excellence desperately need in order achieve a step change in the performance of the control function. Of course, in many cases space has to be created for this new talent. This can be achieved by tackling organizational inefficiencies through the setup of a clear governance framework to ensure that the organization reaches a mature control and reconciliation state and enforces the role as custodians of critical processes.

Furthermore, the next generation of controllers will be one that is accustomed to working within broad corporate ecosystems or domains that promote collaboration in order to develop solutions quickly. These individuals are eager to work with a new generation of executives who proactively engage in technology and vendor discussions because they can see the tremendous value that third party partners can deliver.
The result of this shift is that the role of controllers has moved beyond simply providing controls and reconciliation services, they are now a business partner and in charge of coordinating a complex ecosystems—they also required a much broader range of skills than in the past. Controllers must now be strong in such areas as communications, business case development, risk assessment, competitive analysis and customer relationship management. Only through strategic and smart recruitment processes can such skills be acquired.

One way of resourcing theses skills gaps and adding new capabilities could be to hire new people into the organization another is by improving vendor management. Conversely a change in the company’s projected long-term revenues might call for a reduction in head count in which case strategy to full still important skills gaps should include working with trusted-partners and vendors.

Create trust-based relationships with vendors (Software and Off-shore service providers)

Third parties are playing an ever increasing role in the control and reconciliation business operating model. We strongly believe that organizations must develop trust-based relationships with their strategic partners. In particular, during uncertain times, a common agenda, shared key performance indicators (KPIs) and goals will lead to cooperation that will enable agility and flexibility. Today, as we see the landscape for outsourcing and off-shoring changing, the time to focus on developing stronger relationships to position for future success is now.

As an example, a leading European bank demonstrated the type of value that can be derived from greater reliance on trust-based relationships. Whereas a typical operating group devotes only 10 per cent of its sourcing to trust-based relationships with third-party suppliers, this European bank devotes fully 48 per cent of its controlling activities to a third party vendor at the cost of 10 per cent. This emphasis has delivered real results as this bank’s control productivity is between two and five times higher than that of other players.

However, to achieve this, there is an uncertain road ahead for most companies. A mature and engaged organization can improve its prospects significantly only if its control footprint is clearly defined. An organization with mature controls can help the business react quickly to changing market conditions and execute necessary cost-reduction initiatives.

To provide this level of support, organizations will need to make some radical moves and be comfortable with a high degree of clarity and governance in their control. Those that get it right will be high performing companies — and establish a governed and mature control and reconciliation framework as a core capability that can create competitive advantage.

For more information on Investance capabilities and experience to help your organization develop an effective control and reconciliations framework contact

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Introduction

Throughout The Year Ahead we have reviewed how the financial services industry is facing a decade of re-regulation that will fundamentally alter the way they operate. From the overarching impact of the Dodd-Frank Act, and the minimum capital, leverage and liquidity requirements of Basel III to the reporting requirements of Solvency II and FATCA the common theme is the need for a new level of Data Management.

To address the complex regulatory requirements robust Data Governance is increasingly seen as a key enabler to support business growth, reduce cost of compliance and manage operational risk.

Data governance is a set of core responsibilities and activities in an organisation, tasked with executing the processes required to align data to the needs of the business or compliance in an efficient and controlled manner. A data governance model provides focus on data at all levels of the organisation and empowers people to manage data as a strategic business asset. This enables the organisation to take a holistic view of enterprise data requirements and ensure that data is not an “after thought” in the execution of business strategy.

In the Financial Services industry where effective management and control of data is critical, we believe that organizations that are able to embed disciplined Data Governance will have a competitive advantage. Data Governance encompasses the people, processes, architecture, tools and technology required to deliver data for business consumption and regulatory reporting.

Historically, data has been seen as a technology ‘problem’, but technology teams are often too detached from core business activities to make optimal decisions about data management. The implementation of a robust Data Governance model distributes responsibility for data across the enterprise and provides the basis with which to enhance control and reduce risk.

The business benefits of a robust approach to data governance include:

- Reduced operational risk – a thorough understanding of the ownership, source and purpose of the data creates the transparency required to reveal the effectiveness of business controls.

- Reduced costs – enhanced control frameworks significantly improve downstream reconciliations and exception management processes, ultimately reducing operational costs. In an era of strict capital liquidity requirements, improved data quality will enhance the accuracy of calculations which, in turn, will positively impact capital costs.

- Enhanced customer experience and increase revenues – a good data governance model will provide a holistic view of the customer across the enterprise, improving customer engagement and giving the organisation the opportunity to cross-sell products & services across businesses.

- Ensure compliance – the aftermath of the credit crunch has seen a proliferation in reporting requirements from regulators. A good data governance model will streamline the collection and validation of data, increasing its auditability.
The Data Governance Model

The data governance model consists of the following key components:

1. Data Governance Organisation – data management roles and responsibilities
2. Data Governance Principles – enterprise-wide data principles that specify data management policies
3. Data Architecture – the enterprise-wide technology & business data architecture
4. Technology Infrastructure – the technology infrastructure that supports the delivery of the data architecture
5. Data Governance Processes – a set of processes to support the data organisation

In our Expert Insight publication “Delivering business value through robust data governance” we explore all five components in detail. To read the full publication you can download it from: www.investance.com/research

Using the Data Governance Model

Market Data

Good quality market data is critical to all aspects of the trade lifecycle including pricing, risk, collateral management and finance. Market data is either sourced through third parties (e.g. exchanges) or internally generated (e.g. curves, marks, volatilities). A key challenge for Financial Services institutions is to establish a set of market data which can be used across all the various functions to generate consistent outputs.

Using the data governance model, the market data owner would be the head of a central team that: i) sources data from external providers and ii) generates internal market data. This team will maintain a central ‘golden source’ of data which is used by data consumers across the business functions.

Each business function (e.g. Risk, Finance, Front Office) will nominate a market data information steward, who along with information consumers, are consulted and informed on key changes made to market data by the market data team. The data architecture follows the principle of ‘Golden Source’ with one nominated data repository for each data type (e.g. curves repository, prices repository). Each data repository is either a defined component to hold one data type or a component which holds many different data types. This level of governance ensures that all the market data is sourced from one location and that data changes are managed centrally, establishing consistency in the usage and outputs from the data.

Counterparty Data

Counterparty data is typically the most difficult data category to control and manage. Some banks for example, have centralised customer on-boarding functions into ‘utility’ type services. These functions capture all the relevant counterparty details and distribute the data to various other systems/platforms across the bank – for example, trading systems, settlement systems, CRM systems.

Once distributed, the data is maintained locally by the function which receives and uses the data, creating multiple versions of key counterparty data (SSI, legal entity structure, contact and address information). This approach will create complexities for:

1. Risk functions who wish to consolidate their exposure to the counter party
2. Client services teams trying to provide a joined up approach to management reporting
3. Sales teams aiming to identify cross selling opportunities
In the data governance model, the information owners for all counterparty data would be the client on-boarding team. This team will manage a central counterparty data store which would be used to feed data to all other functions of the business. Information consumers within these functions will determine their specific counterparty data requirements (e.g., settlement account data would only be relevant for the settlement/payment function) and agree how these requirements would be managed locally by the information stewards.

This approach needs to be balanced, however, by ensuring there are robust references to the main data store. The counterparty data architects within technology teams will maintain a ‘master’ architecture view of all the data stores for counterparty data, together with a meta-data view of all the data stored and the relationships between them. Counterparty information owners will oversee changes to the counterparty data model and ensure information consumers and stewards are consulted in respect of these changes.

**Conclusion**

A robust data governance model enables banks to reduce operational risk, improve controls, reduce cost and improve compliance. The implementation of a data governance model starts with empowering people across the organisation by creating key data focused roles and associated responsibilities. Data governance teams are guided by clear data principles and supported using robust data processes, architecture and technology infrastructure.

To ensure and maintain a successful implementation, the data governance model must:

- Be sponsored by senior management
- Not be overly ambitious
- Be flexible to accommodate organisational changes and implement a process of continuous improvement

We believe that robust, flexible, data governance models are the cornerstone of a firm’s ability to leverage data effectively to respond to regulation and deliver real business value.

For more information or to discuss how Investance can assist your organization in developing or refining an effective data governance model please contact Imran Sardar, isardar@investance.com
About Investance

Delivering specialist consulting, technology and outsourcing services to the world’s leading Financial Services organizations.
Introduction to Investance

Investance is a global management consulting, technology solutions and business outsourcing firm dedicated to the financial services industry. Our people have deep expertise in risk management, operations, finance and technology strategy. We blend this expertise with specialist capabilities in advisory, technology and outsourcing to maximize value for the world’s leading financial services organizations.

Expertise Applied

Every sector of the Financial Services Industry is facing another year of unprecedented change and further pressure on resources. As regulatory deadlines approach, attention will shift to the implementation of complex response programs, new operating models, governance structures and data architectures to satisfy the regulators. The Investance team stand ready to assist by bringing the collective insights and experience of our experts with relevant sector knowledge, capabilities and specialisms to each and every engagement.
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