

Global Regulatory Reform

# A vision for banking transformation is emerging – take note

Structural business change in European banking



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## Introduction

Banks face a mass of regulation at a time when fast-evolving customer expectations and new technology are influencing strategic decision-making. Authorities in both Europe and the US have launched a range of initiatives that will significantly affect the legal, financial and operational structures of banks. These developments pose significant challenges for banks' business models and place a premium on structural and operational flexibility, for which banks need to begin planning as soon as possible. In particular, banks will need to reassess their global and current business models related to legal entity structures, booking models, capital structures, funding models and governance frameworks. They will also need to simultaneously enhance their ability to serve clients and become more flexible and resilient.

EY, in collaboration with *The Financial Times*, recently conducted a survey of major banks across Europe. The survey was designed to determine how banks are responding to this complex regulatory reform agenda and, in particular, shed light on the details of any structural change banks are considering or implementing as a result.

The survey findings highlight that for many banks across Europe, strategic reform and the structural implications of regulation are a significant and for many, a top board priority.

Banks are looking at how they respond to specific regulatory requirements on structural issues, but they are also conscious that the rest of the regulatory agenda – capital and liquidity, central clearing of derivatives, securities reform and consumer regulation will impact both the viability of their businesses and where they seek to do business.

The survey findings indicate how far banks have progressed in their thinking, what they are doing to move forward on this agenda and the challenges they are experiencing.

### Survey profile

- ▶ Senior executives at 38 banks from 13 countries across Europe
- ▶ Including 10 global systemically important banks (GSIBs)
- ▶ Assets from all banks taking part exceeded US\$24t (at the time survey conducted)

# Dealing with structural reform is at the core of bank management

## 01

Banks are finding it difficult to deal with the aggregate impact of regulation, making it incredibly challenging to identify the kind of institution they want to be in 2020.

This is due to the continuing uncertainty of major moving parts, assessing the overall impacts and incorporating all of this into the strategic agenda. To achieve compliance with the number and interconnectedness of regulations, banks will require an entirely different approach to the localized and individual regulatory engagement that has been the norm to date.

Some banks already recognize that right-sizing their business legally and operationally is not merely a complex compliance task but an immediate strategic imperative. However, that is not the case industry-wide, and despite the significant resources already dedicated to individual regulatory initiatives, many boards and senior executives simply do not have the bandwidth to focus on

the growing number of issues they face. Yet as the pace of reform steps up, it will become progressively harder – and simultaneously more important – to step back and see the holistic picture.

Structural business change has been discussed at the board level by every bank in the survey, demonstrating that regulatory reform is driving major strategic decisions across the banking sector. Indeed, the changing of business structures in response to regulation is the top priority for a third of all respondents.

GSIBs, in particular, face complex capital and liquidity requirements across multiproduct and multi-jurisdictional business lines. No surprise, therefore, that 90% of GSIBs surveyed said that structural change was a top-three priority.

The findings show that while banks believe they can cope with the individual elements of regulation and recognize that they need to change to do so, assessing the aggregate impact of complex and diverse reforms in a holistic strategic manner is an issue with which the majority continue to struggle.

### How to prepare

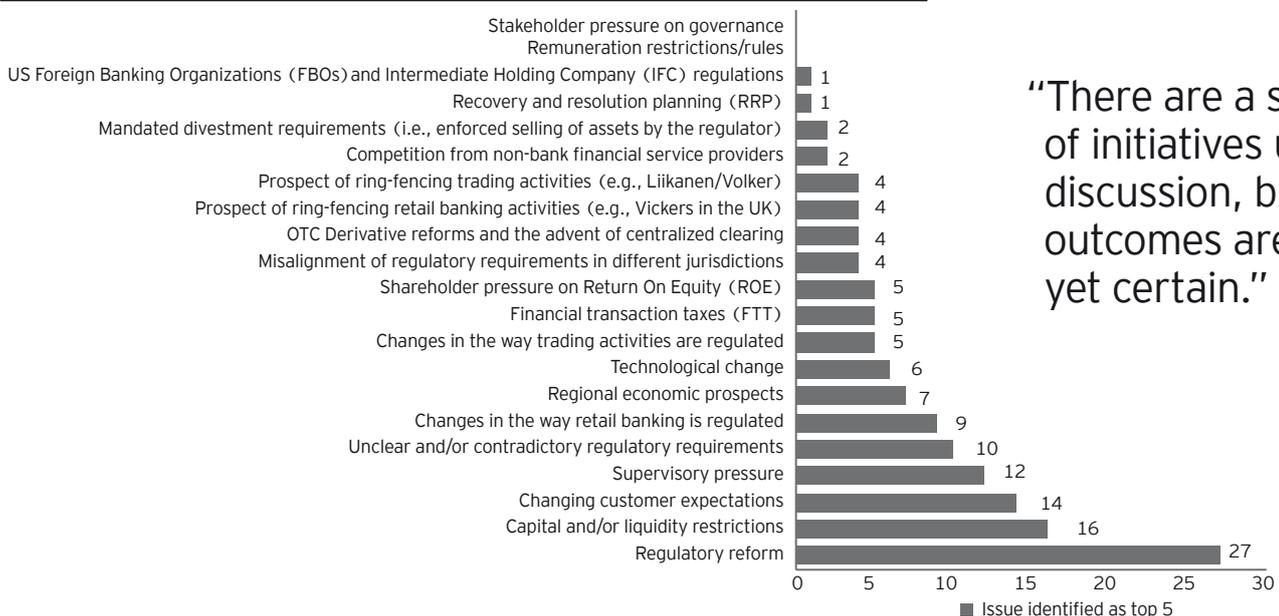
#### Develop an inventory of the regulatory changes that will affect the firm

Regulation is undergoing rapid change. Firms need to be able to inventory the changes, assess how the changes will affect capital, liquidity and other key variables, and develop a timetable for compliance.

#### Make flexibility a hallmark of the new target operating model

The new regulatory environment is still in a state of flux. This could be subject to further change as both economic and financial conditions evolve and as existing reforms make their way through the local regulatory and political process. The ability and capacity to react to these changes and accommodate them alongside business strategy will drive competitive advantage.

### Which of the following external issues are the most important considerations when looking at structural changes to your business?



“There are a slew of initiatives under discussion, but the outcomes are not yet certain.”

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**“There is a real risk of misalignment across regulatory requirements in different jurisdictions.”**

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## Moving beyond universal banking is inevitable

# 02

While banking regulations continue to evolve, it is clear that the banking model of tomorrow will have to be different from that of today.

Even with ring-fencing and other legislation and regulation, bank management appreciate that customers will still want a full range of banking products in the future. Therefore, banking executives by and large feel that it still makes business sense to meet such customer demands from a single institution.

However, reforms are challenging the old universal model in several ways. Regulatory reforms have direct implications for the capital intensity and profitability of individual product lines, the viability of individual

geographies and business units under existing legal structures, and for overall group funding capital and operational models. Put simply, it is clear that banks must be more focused on the products they offer to clients and where they operate.

Moreover, products require capital. The universal banking model in its current form is built on the free movement of capital within the bank whenever and wherever it is needed. The “universal” model in this sense is unlikely to persist in a world where the separation of business activities and their individual funding is at the core of potential reforms in the UK (Banking Reform Bill), the EU (Liikanen) and the US (the Foreign Banking Organization rules and Volcker).

In this environment, addressing legal structures is a top priority for many. This includes the relative merits of the top-level parent company being an operating

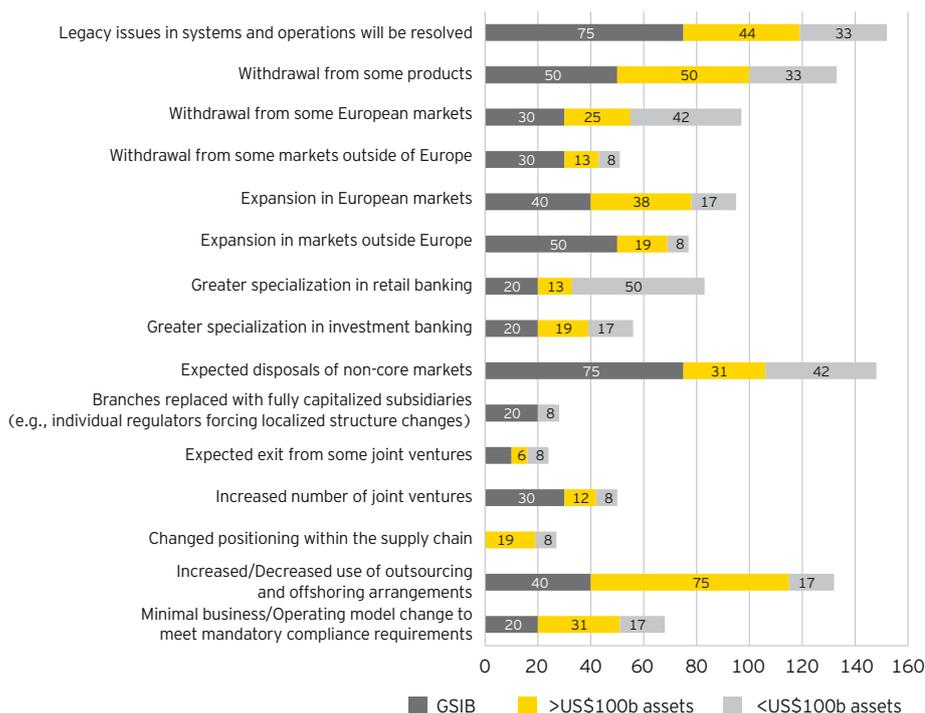
bank in its own right or merely a holding company. The US legislation is also very likely to require foreign banking organizations to set up intermediate holding companies – trapping capital in the process. Meanwhile, reforms to resolution and the introduction of ring-fencing are likely to drive banking groups to a holding company structure with operating subsidiaries that are specialized in certain activities and/or geographies and are funded separately from each other.

The survey indicates that many expect to make changes to the business with more than 40% of our survey respondents expecting to withdraw from some individual products, make disposals in non-core markets and shake up their outsourcing and offshoring arrangements by 2017.

With the greatest regulatory pressures, GSIBs are expecting to make more dramatic changes, with 70% expecting to make disposals in non-core markets, 50% expanding in markets outside of Europe and 50% withdrawing from some products. A total of 30% of GSIBs also expect to increase their number of joint ventures.

However, despite this level of change and regulatory pressure to ring-fence, all of the banks in our survey that said they operate a universal business model also expected to retain this model in the future.

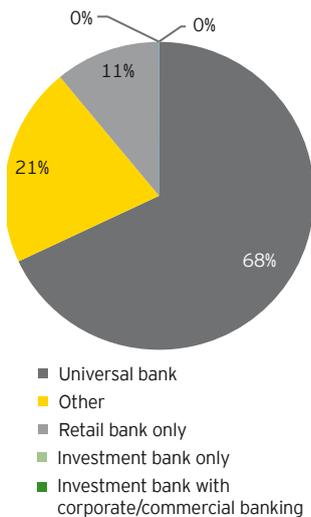
### How do you envisage your business will change in the next three to five years? (tick all that apply)



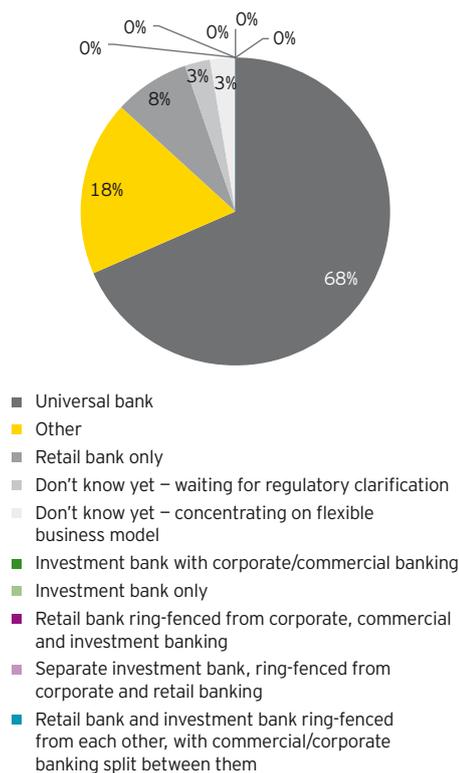
“Our banking model is – and will remain in this new environment – a universal banking model. We think this is the most resistant to systemic risk.”

“We are simplifying our business and exiting complex products, particularly those with a complex support element, and tackling the sprawl of our business.”

### How would you describe your current business model?



### In the future, which business model are you most likely to adopt for your bank?



### How to prepare

#### Understand in detail how everything adds to the bottom line

The new environment will be more costly in terms of capital, liquidity and operating costs. If banks are to earn their cost of capital, they will have to focus on lines of business where they have a competitive advantage. They will need to understand where to invest and where to reposition/exit. They should also be looking at repositioning or exiting businesses where they don't have a comparative advantage – where they are too small to play or where the economics do not make sense. To frame these decisions, banks may find it helpful to employ tools that dynamically model the combined impacts of strategic choices on capital, liquidity and leverage both in subsidiaries, such as a ring-fenced bank, as well as in the group as a whole.

#### Improve liquidity management

In this new environment, liquidity will be under increased scrutiny, both from supervisors and investors. The bank will need to measure and manage liquidity not only on a group basis, but in each legal vehicle. They will need to take into account the restrictions on shifting funds from one legal vehicle to another that will require building and maintaining a capability to track liquidity sources and uses by legal vehicle.

Another area to assess and align to best practice, as part of recovery and resolution strategies, is collateral to facilitate access to funding.

- ▶ What are the unencumbered assets? Are they owned outright or re-hypothecated (and therefore subject to withdrawal by the customer)?
- ▶ What are the demands for additional collateral to which the bank might be exposed?
- ▶ What cash could the bank realize, from whom, in what time frame (and are legal agreements in place)? Has the bank pre-positioned the collateral?

## Challenging times ahead for cost, efficiency and resourcing

# 03

Banks are significantly underestimating the scale and scope of resources required to implement structural changes necessitated by the regulatory agenda.

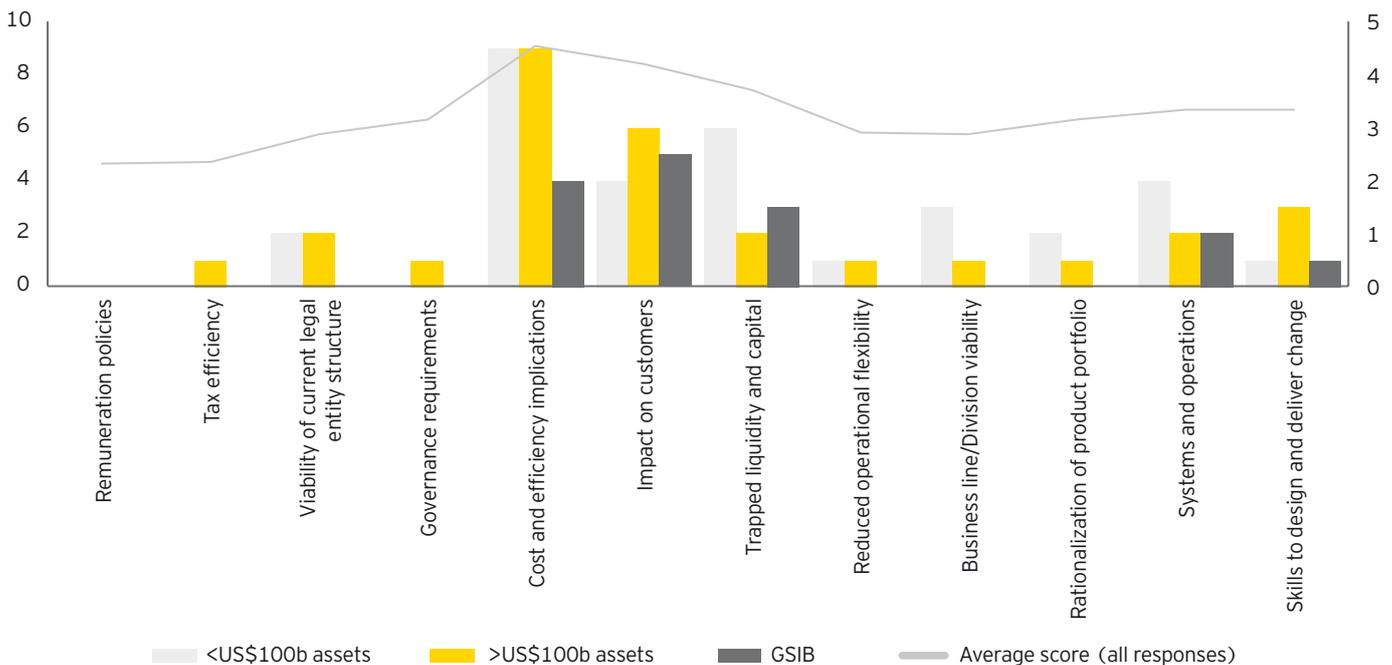
Institutions are recognizing that data management, risk governance, risk models and a whole host of other individual aspects of their day-to-day business need to improve. However, the capacity of banks to operationalize the level of improvement that they need is unclear. Indeed, few banks in our survey identified resources in systems and operations as a priority despite their criticality to deliver change, effectively and efficiently.

Significant bandwidth challenges in these areas will intensify over the next three years for many firms.

For some, the resource challenge is sufficiently severe that there is a real risk of failing to meet regulatory timetables as the volume, profile and complexity of the reform agenda increases still further.

The cost implications of implementing reform are significant, and the survey revealed that this is a real concern for small banks in particular. Indeed, cost and efficiency implications collectively worried more respondents than any other internal issue – and throughout the survey, there was an ever-present focus on reducing costs and streamlining unnecessary business complexity.

### Which of the following internal issues are of most concern when looking at structural business change?



Data: respondents asked to rate issues on a scale of 1 to 5, where 1= "not an issue."

“What we have are product-built systems that don’t allow for a universal view of customers.”

## How to prepare

### Review financing vehicles and understand their impact on investors

The introduction of a bail-in potentially increases risk to investors. Guarantees and cross-default provisions may be scaled back, so that risk to investors will vary according to the legal vehicle issuing the obligation and the exact spot in the queue that the obligation has with respect to the bank’s cash flows. Investors and rating agencies are likely to demand increased transparency. Banks should consider conducting an entity priority analysis to document current interdependencies among outstanding debt and work out “rules of the road” for new issuances. This will help banks move from their current financing arrangements toward the financing appropriate for the new regulatory/ resolution regime.

### Improve cost control through the creation of an operating subsidiary

In this new structural environment, banks will have many subsidiaries, and each will require services, such as software, payments processing and payroll/ expense management. It may make sense – to the extent the ring-fence requirements permit it to do so – for the group to provide these centrally, which can generate economies of scale as well as greater control. It may also make sense to put these central group services into one or more operating subsidiaries that would transact with the financial subsidiaries at arm’s length on the basis of service-level agreements. Such agreements should generate stable cash flows to the operating subsidiary – which may also present opportunities for raising capital at attractive rates.

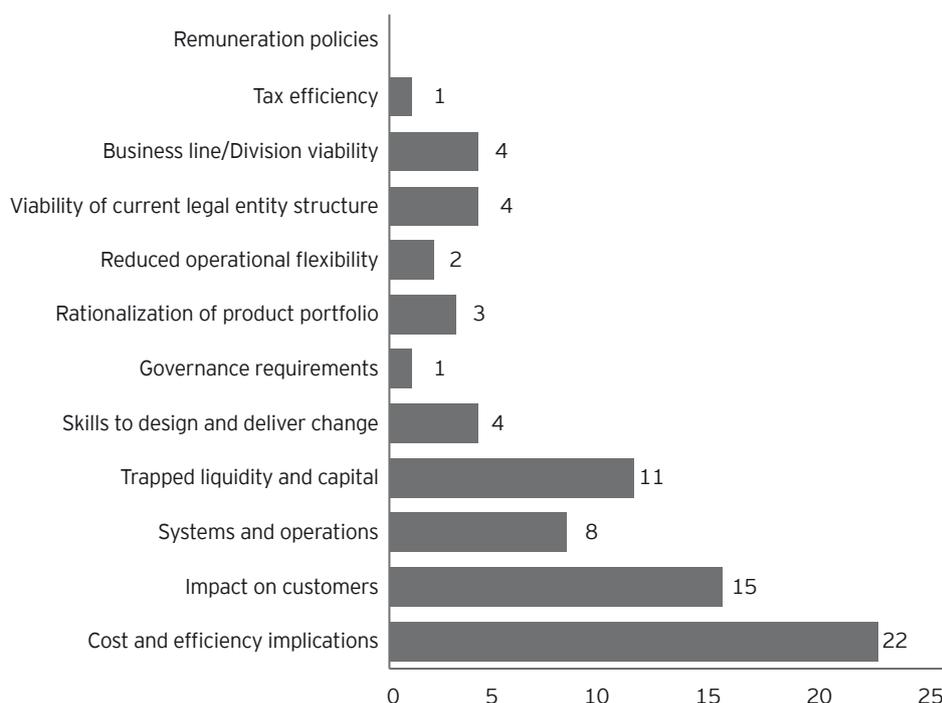
### Review booking models and business processes

Banks should review their booking models to assure that they are minimizing counterparty risk, optimizing capital utilization and facilitating liquidity management. In particular, banks should give consideration to contracting, as far as jurisdictions will allow, in a “single name” (legal vehicle) from a single venue. This will enhance hedging and netting and reduce capital requirements.

### Review the tax situation

Key aspects of the existing bank structure are likely to have been driven by tax efficiency. Changing the structure is likely to have significant tax implications for both ongoing efficiency as well as for transactions that may be necessary to implement the new structure. Furthermore, recent changes in the tax environment for banks have altered the parameters for optimal tax structuring. These changes include tax losses accumulated as a result of the crisis, the introduction of bank levies and financial transaction taxes, and the growing impact of banks’ tax affairs on their reputations with stakeholders. A review of the current situation and the development of protocols for the new world will support and enable the transition to an efficient new structure.

### Which of the following internal issues are of most concern when looking at structural business change?



## Conclusion

### As banks contemplate the huge challenge of aligning regulatory reform to their business strategies, there are still some significant pieces of the regulatory puzzle missing.

With such uncertainty, the key to long-term success will involve responding holistically to the many individual strands of the regulatory agenda while remaining client-focused and, crucially, retaining operational flexibility.

Banks are concerned about cost and efficiency implications of structural change – but few recognize the full extent of the resource challenge in addressing it. They are already under pressure, and a lot of their change management and skills resource that will be needed to implement this agenda is running over capacity and is likely to be stretched even further. A different approach to prioritizing and investing across the agenda will be needed to ensure resources are deployed in the most effective way.

Already, the more forward-thinking banks are adopting a “no regrets” approach by investing in more than one potential outcome now, well aware that by the time there is regulatory clarity it will certainly be too late to execute as a market leader and thereby drive competitive advantage.

There are additional shareholder pressures to accelerate structural change, compounded by the European Central Bank’s Asset Quality Review and ongoing market volatility, particularly in business lines where profitability is under pressure. Banks also need a globally consistent view of the resolution regime and clarity on how resolution strategies are to be implemented at national and regional levels before they can really progress their strategic reforms.

Clearly, there is no “one size fits all” model for banking. However, we are in no doubt that the “universal” bank of tomorrow – to which many banks are still committed – will look very different from the “universal” bank of today. Global banks will continue to offer a wide product range to a geographically diverse customer base, but the breadth of that product range and where it is offered is likely to change dramatically as banks focus on areas of genuine and sustainable relative strength and scalability.

#### How to prepare

- ▶ Develop an inventory of the regulatory changes that will affect the firm
- ▶ Make flexibility a hallmark of the new target operating model
- ▶ Understand in detail how everything adds to the bottom line
- ▶ Improve liquidity management
- ▶ Improve cost control through the creation of an operating subsidiary
- ▶ Review booking models and business processes
- ▶ Review financing vehicles and understand their impact on investors
- ▶ Review the tax situation

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## Contacts

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We can bring together professionals from across our services, ranging from regulation and compliance, performance improvement and operations, through to tax, accounting and transaction support. We also have a number of former senior regulators and central bankers who can bring insight into the future regulatory environment as it evolves.

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