Ten Key Regulatory Challenges facing the Banking & Capital Markets Industry in 2016

The complexities of the current regulatory environment pose significant challenges for the banking & capital markets industry, as regulators continue to expect management to demonstrate robust oversight, compliance and risk management standards.

The pressure from regulators such as APRA, ASIC, ACCC and AUSTRAC, together with other stakeholders such as customers, investors and counterparties will continue into the future. It is likely that existing challenges will be augmented by new unforeseen ones.

Although many of these challenges are particularly pressing for the largest (and globally active) firms, smaller institutions are also struggling to optimise their business models and infrastructure to address the growing scrutiny and demands.

The following are some of the key regulatory issues that are likely to impact our clients through 2016.

1. Governance, Culture and Conduct

At KPMG we distinguish between a firm’s governance, culture and conduct differently. The responsibilities and accountabilities for each are different, but taken together, they form a key theme for 2016.

Despite heightened attention from regulators and external stakeholders to strengthen governance structures and risk control frameworks across the industry, instances of misconduct (i.e. professional misbehaviour, ethical lapse, compliance failures and breach of codes of conduct) continue to be frequently reported.

Regulators have come to see shortcomings in culture and conduct as the root cause. They are looking to boards of directors and senior executives to drive organisations towards cultural and ethical change. Boards and senior executives are now expected to champion the desired culture within their organisations, to establish values, goals, expectations and incentives for employee behaviour consistent with the stated organisation culture, and to set a ‘tone from the top’, by exhibiting their commitment to the stated values and expectations through their own words and actions.

Line and middle managers, who are frequently responsible for implementing organisational changes and strategic initiatives, and who interact daily with staff, are expected to be similarly committed to adopting and manifesting the desired organisational culture to ensure the ‘mood in the middle’ reflects the ‘tone from the top’.

The regulatory focus also extends to how organisations implement their business strategies. Regulators expect firms to place the interest of all their customers and the integrity of the market ahead of profit maximisation. Further, they will consider the business practices firms utilise and the associated customer costs relative to both the perceived and demonstrable benefit of a product or service to the customer.

Following significant market conduct failures such as FX and BBSW/Libor rate-rigging scandals and mis-selling of financial products, the Financial Conduct Authority (FCA) in the UK has introduced the Senior Managers Regime which holds senior management personally accountable for misconduct caused by poor organisational culture.

Areas to watch going forward may include: trader surveillance; nonfinancial companies that provide third-party payments/billings processing to their customers; providers of retirement savings and superannuation, loans and marketplace lenders.

Increasingly, external bodies such as regulators, shareholders and rating agencies are looking to firms to actively demonstrate good culture and prove conduct compliance, rather than simply talk about it.
2 Capital and Liquidity

Enhanced Prudential Standards for large domestic banks, foreign banking organisations and other non-bank financial companies have brought capital planning and liquidity risk management to the forefront, as regulators have sought to restore both public and investor confidence in the aftermath of the financial crisis.

Financial institutions (FIs) are required to demonstrate their ability to develop internal stress testing scenarios that properly reflect and aggregate the full range of their business activities and exposures, as well as the effectiveness of their governance and internal control processes. Large FIs must also provide information that will allow regulators to perform sensitivity analyses on their ability to manage their funding sources, signalling a step up in the scrutiny of FIs’ liquidity management and how they would fare under system-wide financial stress.

Efforts to formalise the link between capital, funding and liquidity management include:

- Perhaps the most significant change to capital requirements, the Fundamental Review of the Trading Book (FRTB) will set a new market risk framework for determining the amount of capital required to support capital markets activities. The changes in capital will be significant and will require banks to assess their business structures. The implementation programs are large. Banks will need to invest considerably in 2016 to meet implementation timelines in 2017/18.
- Total loss absorbing capacity (TLAC) held by systemically important banks. The key objective is to ensure that G-SIBs have sufficient ‘loss absorbency’ to enable authorities to implement an orderly resolution without impacting the stability of the broader financial markets. While Australia has no G-SIBs, the Australian Government’s response has endorsed APRA’s recommendation to implement a domestic TLAC framework.
- Basel III capital and liquidity minimum standards, namely the Net Stable Funding Ratio (NSFR) and the 30-day Liquidity Coverage Ratio (LCR). LCR was introduced into Australia in 2015. Both measures are complementary, with LCR focussed on the short term and NSFR on the medium and long term. While NSFR does not come into effect until 2018, APRA is expected to begin the consultation and review process through 2016.
- An extensive refresh of standardised credit risk regulatory capital standards with reduced reliance on external credit ratings; enhanced granularity and risk sensitivity; updated risk calibrations and provide more comparability with Internal Ratings-based categorisation.
- Proposed revisions to standardised approach for operational risk. This may impact advanced banks through the proposed capital floor. It is also expected that the Advanced Measurement Approach to Operational Risk will be removed from the regulatory framework.

3 Data Quality, Aggregation and Reporting

Although a long-standing industry problem, many FIs continue to struggle with improving their risk data aggregation, systems, and reporting capabilities. Banks working to comply with the Basel Committee on Banking Supervision Principles (BCBS 239) are particularly pressured, as regulators continue to lack confidence in the industry’s ability to produce accurate information on demand. Enhancing process controls, data tracing and risk reporting requirements are also top of mind for broker-dealers and investment banks. Compliance to AML and AUSTRAC threshold transaction reporting (TTR) continue to cause significant difficulties.

Globally, anticipated requirements, such as the pending single-counterparty credit limit (SCCL) rule, which would likely require organisations to track and evaluate aggregate exposure to a single counterparty across the consolidated firm on a daily basis, further fuel the industry’s data concerns. Quality remains an ongoing challenge, with data integrity continually compromised by legacy technologies, inadequate or poorly-documented manual solutions, inconsistent taxonomies, inaccuracies, and incompleteness.

Management will need to consider both strategic-level initiatives that facilitate better reporting, such as a regulatory change management strategic framework, as well as more tactical solutions, such as conducting model validation work, tightening data governance, and increasing employee training. By implementing a comprehensive framework that improves governance and emphasises higher data quality standards, FIs should realise more robust aggregation and reporting capabilities, which, in turn, can enhance managerial decision making and ultimately improve regulatory confidence.

4 Cybersecurity, Onboarding and Data Privacy

Cybersecurity has become a very real regulatory risk distinguished by increasing volume and sophistication. Failures in cybersecurity have the potential to impact operations, core processes, and reputations, but in the extreme can undermine the public’s confidence in the financial services industry as a whole. FIs are increasingly dependent on information technology and telecommunications to deliver services to their consumer and business customers, which, as evidenced by recently publicised cyber hacking incidences, can place customer-specific information at risk of exposure.

Many banks have invested heavily in client onboarding, yet processes remain largely manual, error prone, time consuming and risky in terms of compliance with global regulatory regulations and to the client experience. Australian banks need to comply with both domestic and international AML, KYC and FATCA/GATCA regulations. We expect that banks will need to embark or extend technology-based onboarding solutions that can:

- Enhance and reshape the customer experience
- Reduce operational costs, and improve operational efficiencies and controls
Address gaps in (global) regulatory compliance

Use metadata to model policies for complying with regulation

Establish consistency in policy and data quality across the organisation and geographic regions

Advance data quality and governance

Some firms are responding to this linkage between cybersecurity and privacy by harmonising their approach to the two challenges. Protecting the security and confidentiality of customer information and records is of paramount concern to institutions and regulators alike. Areas of regulatory concern related to privacy include: data access rights and controls; data loss prevention; vendor management; training; and incident response.

5 Fintech Pressures

The banking and capital markets industry is experiencing an increase in activity and availability of new products and services introduced to meet a growing demand for efficiency, access, and speed. Broadly captioned as Financial Technology, or fintech, innovations such as internet-only institutions, virtual currencies, mobile payments, crowdfunding, and peer-to-peer lending are changing traditional banking and investment management roles and practices as well as risk exposures.

The fact that many of these innovations are being brought to market outside of the regulated financial services industry – by companies unconstrained by cumbersome legacy systems, bricks-and-mortar infrastructures, or regulatory capital and liquidity requirements – places pressures on FIs to compete for customers and profitability, and raises regulatory concerns around the potential for heightened risk associated with consumer protection, risk management, and financial stability.

Regulators will be watchful of the key drivers of profit and consumer treatment in the sale of new and innovative products developed within and outside of the regulated financial services industry, and will separately seek appropriate regulatory regimes to capture the risks posed by new products and services while remaining cautious not to stifle innovation or limit credit availability.

6 Investigations and Remediation

In Australia there has been a dramatic increase in the number and scale of investigations across banking and capital markets. Globally over the last 5 years, international banks have paid over $US260bn in legal settlements and fines. While Australian banks have improved the capture and storage of the information, voice, email, instant messaging and chat-rooms. While many banks have improved the capture and storage of the information, the greater challenge is to provide comprehensive analysis of the information and to take demonstrable action based on the outputs.

We expect a number of developments in 2016:

- Firstly, the volume and complexity of the investigations will grow. Investigations will move from reviewing the action of individual traders/operators to more sophisticated activity such as algorithmic and electronic trading.

- As seen in the UK and US, a move beyond financial corporate penalties to action against individuals such as criminal prosecutions.

- The role of senior management will be an increased focus. Consideration may include – management oversight of staff, the action taken by management at the time of an incident, consistency of the response across the business and whether the bank performed wider internal investigations once misconduct was recognised.

The current crop of investigations are likely to highlight weaknesses within banks control, operating processes and systems. Banks will need to implement remediation programs to respond to the finding. The remediation may take several courses – upgrade in codes of conduct, increased training, further resourcing in compliance/oversight and technological enhancements to prevent and/or report inappropriate activity.

The implementation of remediation programs will be of significant interest to management, regulators and auditors.

7 Cost Effectiveness and Sustainability of Compliance

Compliance continues to be a top concern for organisations, as the pace and complexity of regulatory change, coupled with increased regulatory scrutiny and enforcement activity, have pushed reputation risk to new levels. This has resulted in expanded compliance teams and budgets.

At the same time, compliance and regulatory functions will not be immune from bank-wide cost reduction programs. The challenges for banks will be to reduce cost without diminishing oversight and control. The introduction of technology, automation and the selected use of centres of excellence and third party vendors can form part of efficiency programs.

Banks will need to maintain flexibility through this process, as regulatory requirements grow and shift. Resources will need to be agile and redeployed, rather than simply become accretive.

8 Conduct Monitoring

Misconduct scandals have resulted in heavy fines, civil and criminal investigations, new regulatory requirements and industry pressures. In response, banks are significantly investing in conduct monitoring and surveillance. The surveillance is increasingly shifting from ‘look-back’ to real-time, near real-time and even forward-looking behaviour analytics.

Data capture is vast – including trade and transaction reporting, voice, email, instant messaging and chat-rooms. While many banks have improved the capture and storage of the information, the greater challenge is to provide comprehensive analysis of the information and to take demonstrable action based on the outputs.

While banks need to ensure compliance to codes of conduct and regulation relating to money laundering, financial crime, insider trading, front-running, and other market manipulation, it will be essential for banks to employ a systematic and comprehensive approach to better manage both known and emerging regulatory and legal risks. They will need to proactively respond to market structure reforms and new forms of misconduct.
Resolution Planning
The global financial crisis highlighted the need for banks to have in place substantive resolution plans. In 2011, the Financial Stability Board (FSB) published the “Key Attributes of Effective Resolution Regimes for Financial Institutions”, that provided an international framework for financial crisis resolution. APRA issued a consultation paper in 2012 “Strengthening APRA’s Crisis Management Powers”, that sought to broaden APRA’s investigation and direction authority. The Australian government has endorsed APRA’s crisis management powers.

We expect that APRA will be working with banks through 2016 to ensure that resolution plans are creditable and practically implementable in times of crisis. What needs to be noted is that resolution is about retaining banking service functionality, not saving the bank!

Cross-Border Regulatory Change
The largest Australian banks must now understand and manage regulatory mandates across more jurisdictions and services than ever before. Regulatory obligations and cross-border pressure points, such as BSA/AML (Bank Secrecy Act/Anti-Money Laundering) in the US and MIFID2 in Europe, together with other financial crime requirements, continue to challenge local banks that operate in global locations.

Given the size and complexity, banks need to move beyond a reactionary mode, to a more coordinated and strategic deployment to tackling high-impact regulatory change.

To address these challenges, banks will need to consider implementing a regulatory change management framework that is capable of centralising and synthesising current and future regulatory demands. This would incorporate both internally developed and externally provided governance, risk management, and compliance (GRC) regulatory change tools.

This framework will enable institutions to improve coordination across their operating silos (business and location) and gain new insights that can improve overall performance, ensure risk management frameworks and compliance controls are integrated into strategic objectives, avoid redundancy and rework, and better address regulatory expectations.

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