

GLOBAL RISK 2014–2015

BUILDING THE TRANSPARENT BANK



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EXECUTIVE SUMMARY

GLOBAL BANKING HAS ENTERED a new era of comprehensive reform and regulatory scrutiny. The challenges of this environment will require banks to undertake a shift in mind-set. Regulation cannot be fought off. Instead, banks should adopt a “good citizen” approach that embraces and proactively addresses the broad intent of today’s hyperregulation. Doing so will require banks to commit themselves to increased transparency, both internal and external.

In the three chapters that follow, this report assesses the following:

- The health of the global banking industry and the underlying sources of the significant variation in regional performance
- The state of regulatory reform, classifying all measures into three broad clusters that provide a framework for banks to take action
- The management implications of the new era, outlining an approach for defining clear options and a regulatory roadmap

Global Banking Regains Economic Profitability

For the first time since the start of the financial crisis in 2007, the banking industry has moved beyond recovery and returned to economic profit (EP) on a global scale. Beneath that overall improvement, however, there is still sharp divergence among regions in both the level and trend of performance.

- Most notably, North American banks are again growing and producing sizable EP.
- In Europe, and only there, banks continue to show little sign of recovery, delivering negative EP.

- The positive performance of banks in the Middle East and Africa, along with that of North America, helped drive the global increase in EP.
- Banks in Asia-Pacific outpaced all other regions in value creation, even as their performance plateaued.
- South American banks lost ground: their EP remained positive but shrank significantly for the second year in a row.

Worldwide, the new era of regulation will have an uneven impact on the various components of bank performance. As a consequence, some regions are in better shape than others for addressing the shifting regulatory environment.

The Brave New Era of Comprehensively Regulated Banks

Global banking has entered a new era in which every region, product, and legal entity will be closely regulated.

To assess the current status and future effects of regulation, we have classified the entire spectrum of reforms into three clusters: financial stability, prudent operations, and resolution and separation.

- *Financial Stability.* This is the most developed area of reform. Many banks already exceed heightened regulatory requirements for capital and liquidity, yet both areas remain bank priorities because investors increasingly require additional cushions above and beyond the mandated minimums, and regulators aim to harmonize risk measurement. Fulfilling these market expectations for capital and liquidity will increasingly become a competitive factor for banks.
- *Prudent Operations.* Prudent operations are focused on preventing future episodes of misconduct. We believe that regulator targets for prudent operations are clear. The drastic enforcement of sanctions, the increased personal liability of “acting persons” (those actively involved in the business), and the partial criminal liability of executives and top management reflect regulators’ intent to trigger a cultural change in banking, pushing banks to act much more transparently and proactively vis-à-vis supervisory authorities and the market. It is now up to the banks to implement reforms—and to control themselves.
- *Resolution and Separation.* The central goal is to achieve ways to protect functions critical to the real economy and to avoid any need for future taxpayer-funded bailouts. Some progress has been made on financial stability and prudent-operation measures related to resolution. Yet if a bank were to fail today, the achievement of the central goal would still be in doubt. While banks have been required to design their own recovery and resolution plans, these “living wills” have been part of the problem rather than the solution. As a consequence, the discussion of structural bank

reform as a means of reducing complexity and protecting critical economic functions is a growing priority. Next steps by U.S. regulators—which allowed the living wills of several major banks to fail—are eagerly awaited, as are changes to the EU’s separation proposal and G20 endorsements from the leaders’ summit in Brisbane.

Shifting the Mind-Set to Transparency

Banks face a shift in mind-set as they adapt to full transparency and a good-citizen approach to regulation. To engage reforms proactively, a bank will need to make an assessment of regulatory measures, create a regulatory target picture to identify pressure points in its current setup, and deduce management options and a respective regulatory roadmap.

In support of this transition, banks must operationalize the management of their regulatory project portfolio and establish a comprehensive control framework. The framework should be based on the three-lines-of-defense model. This approach is crucial for effectively reducing nonfinancial risk such as fraud, misconduct, and reputational damage.

The improvement of bank data and IT capabilities is also a central intent of regulators, with a goal of enhancing the industry’s transparency. Compliance will require banks to lay a foundation for risk data aggregation and reporting, as well as to improve data delivery capabilities.

Banks could find themselves thinking about this transparency-driven pressure as a necessary evil. However, increasing transparency also brings multiple benefits that banks should capture. Total transparency is not just a mantra or marketing catchphrase for banks. Nor is it simply a new set of legal obligations and constraints. It will be a permanent and defining characteristic of global banks on the leading edge of change.

GLOBAL BANKING REGAINS ECONOMIC PROFITABILITY

FOR THE FIRST TIME since the start of the financial crisis in 2007, the banking industry has moved beyond recovery and regained overall profitability on a global scale.

Beneath that improvement, however, there is still sharp divergence among regions in both the level and trend of recovery. Most notably, banks in North America are again growing and showing sizable economic profit (EP), while those in Europe show little sign of recovery.

Banks in North America, the Middle East, and Africa continued to surge ahead.

To determine the state of health and to assess the overall performance of the global banking industry, The Boston Consulting Group assessed the EP generated in 2013 by more than 300 retail, commercial, and investment banks. The benchmarking accounted for more than 80 percent of all banking assets worldwide. EP—which weighs refinancing costs, as well as operating and risk costs, against income—provides a comprehensive measure of the financial conditions that banks face in an era of risk and overarching regulation.¹

As we forecast in last year's report, the industry overall regained profitability in 2013. (See *Global Risk 2013–2014: Breaching the Next Banking Barrier*, BCG report, November 2013.) Banks, averaged globally, created positive EP of €18 billion, or 3 basis points as a percentage of total assets, compared with negative EP ranging from –6 to –23 basis points during the previous four years.² (See Exhibit 1.)

The global increase in EP was driven by the positive regional performance of banks in North America as well as the Middle East and Africa, where banks continued to surge ahead. Banks in Asia-Pacific outpaced all other regions even as their performance plateaued. South American banks lost ground: their EP remained positive but shrank significantly for the second year in a row. In Europe, and only there, banks continued to deliver negative EP.

An assessment of the components of economic profit reveals the basis for these differences in regional performance and suggests paths banks might take to achieve positive value. (See Exhibit 2.)

Europe. In 2013, six years after the crisis struck, banks on the Continent and in the UK, the only banking region still mired in negative value creation, recorded EP of –40 basis points. Banks in southern Europe barely

EXHIBIT 1 | Global Banking, Driven by the Comeback of North American Banks, Has Regained Economic Profitability



Sources: Bank Scope; annual reports; BCG Risk Task Force database; Bloomberg; BCG analysis.

Note: EP = economic profit. Because of rounding, values may not add up to the totals shown. The order of the regions reflects a focus on Europe and North America; the remaining regions are sorted according to total assets. Exchange rates from the end of 2013 are used for comparability.

¹Total assets are lower than in Europe and Asia-Pacific because of U.S. and local generally accepted accounting principles.

advanced. The UK and the rest of continental Europe fared somewhat better but still remained negative.

On an absolute basis, gross income in the region decreased in parallel with total assets, which fell amid a step-by-step deleveraging in Europe in 2013. As a result, gross income remained flat on a per-asset basis. Of all the regions, Europe recorded the lowest gross-income position. At the same time, total costs on a per-asset basis also remained nearly flat, owing to the combined effects of refinancing, risk, and operating costs. While refinancing costs decreased as a result of Europe’s persistently low interest rates and risk costs remained constant, operating costs rose further.³

In the medium term, refinancing costs are likely to rise in Europe, as European Central Bank (ECB) policy may shift. In order to escape persistent negative EP, European banks

should focus on either the top line or the operating-cost base.

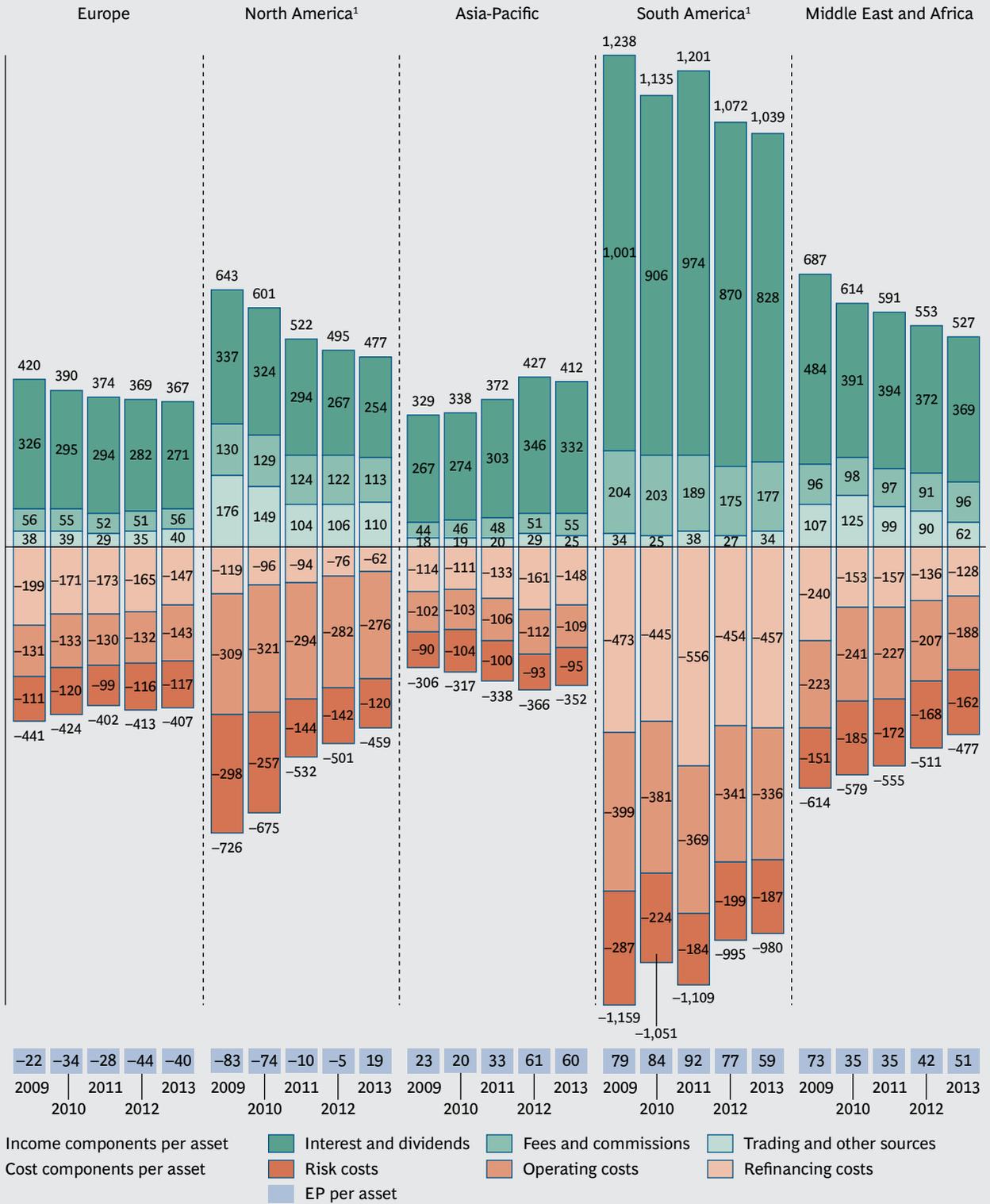
North America. Banks in the U.S. and Canada achieved EP of 19 basis points, advancing from recovery to growth by generating positive EP for the first time since the crisis.

Quantitative easing by the U.S. Federal Reserve helped reduce refinancing costs substantially in North America.⁴ However, since 2013, the Fed has ratcheted back, or “tapered,” these asset purchases, potentially leading to a more market-driven environment and higher-spread funding costs for banks.

Another driver of value creation was the decrease in risk costs due to an improved macroeconomic environment. With operating costs decreasing by only 2 percent on a per-asset scale, there is still room for further value creation. This is a prerequisite for

EXHIBIT 2 | Both Income and Costs Continue to Decrease on a Per-Asset Basis Globally, with Regional Variations

Components of EP generated by global banks, relative to total assets, 2009–2013 (basis points)



Sources: Bank Scope; annual reports; BCG Risk Task Force database; Bloomberg; BCG analysis.

Note: EP = economic profit. All values are per asset: that is, the total value in euros divided by the total assets in euros, expressed in basis points. Because of rounding, values may not add up to the totals shown. The order of the regions reflects a focus on Europe and North America; the remaining regions are sorted according to total assets. Exchange rates from the end of 2013 are used for comparability.

¹Total assets are lower than in Europe and Asia-Pacific because of U.S. and local generally accepted accounting principles.

North American banks to stay competitive. For this reason, both lean and delayering programs are high on the agenda of many banks.

Asia-Pacific. The Asia-Pacific region surpassed all others in positive value creation in 2013, as banks there generated EP of 60 basis points. Still, the strong surge of previous years began to level off.

Lean and delayering programs are high on the agenda of many banks.

The region's increase in gross income on an absolute basis did not keep pace with growth of total assets, leading to a decrease in gross income on a per-asset basis. Similarly, a cost decrease—driven mainly by lower refinancing and operating costs on a per-asset basis—outweighed the growth of risk costs.

Many Asia-Pacific banks have done little to boost efficiency, particularly in the risk function, and they were not able to compensate for falling income. In China, for example, total added value grew just 7 percent in 2013, and on a per-asset basis, it actually decreased by 1 percent. By contrast, in 2012, added value nearly doubled, including on a per-asset basis. The new figures suggest that Asia-Pacific banks have yet to adapt fully to the region's maturing market and possibly slowing growth pace.

South America. Banks in South America generated EP of 59 basis points in 2013—a strong performance but less robust than in 2012—as a decrease in gross income outweighed a slight dip in total costs on a per-asset basis.

The weakening gross income resulted largely from the reduced interest income of a market in which GDP growth has slowed. High-return credit products, including consumer and car financing, were partly replaced by secured products, including mortgages and commercial real-estate loans.

To return to sustained EP growth, South American banks need to focus on efficiency, streamlining their organizations to match the changing risk profile of their business.

Middle East and Africa. Bank performance continued to surge in the Middle East and Africa, generating an economic profit of 51 basis points on a per-asset scale and boosting value creation by 20 percent in a single year.

Benefiting from solid macroeconomic conditions, banks in the Middle East and Africa made the most of a market that is still not mature. Gross income grew nearly in parallel with total assets, resulting in a slight decrease on a per-asset basis. Meanwhile, refinancing, operating, and risk costs grew more slowly than total assets, producing the significant increase in EP.

DESPITE the positive overall development of the global banking industry, regional differences are clearly evident. Most notable is that North America has recovered and moved back to positive EP, while Europe continues to stagnate in negative value creation. Worldwide, the new era of regulation will have an uneven impact on the various components of bank EP. As a consequence, some regions are in better shape than others for addressing the shifting regulatory environment.

NOTES

1. A bank's EP is calculated by measuring its gross income and subtracting refinancing and operating costs as well as loan loss provisions (LLPs) and capital charges (common equity multiplied by the cost of capital). LLPs and capital charges are barometers of macroeconomic and regulatory conditions, which together represent the risk costs incurred by banks.
2. For every €1 in total assets, 0.03 euro cents of EP is created.
3. On an absolute basis, operating costs in Europe were constant from 2012 through 2013; the increase relative to total assets was due to a decrease in total assets at the same time that operating costs remained constant on an absolute basis.
4. Quantitative easing—a monetary policy measure of central banks—aims to stimulate economic growth by purchasing government bonds and other securities from banks and other private institutions to raise the volume of money in the market, increasing liquidity and supporting lending by banks.

THE BRAVE NEW ERA OF COMPREHENSIVELY REGULATED BANKS

GLOBAL BANKING HAS ENTERED a new era in which every region, product, and legal entity is going to be closely regulated.

To assess the current status and future effects of regulatory reform, we have classified the entire spectrum of regulatory reforms, grouping them into three clusters: financial stability, prudent operations, and resolution and separation. (See Exhibit 3.)

Financial Stability: Expectations Exceed Regulators' Intent

Since the crisis began, establishing and safeguarding global and local financial stability have been regulators' highest priorities. As a result, financial stability is the most developed area of reform. Fundamental requirements have been revised or reinstated, primarily on the basis of Basel III standards. Those requirements now form the global regulatory baseline for capital, leverage, and liquidity.

Many banks already fulfill or even exceed the heightened requirements for capital and liquidity, yet both remain top priorities for banks. This is because investors increasingly require additional cushions above and beyond the regulatory minimums. Fulfilling these market expectations for capital and liquidity will become more of a competitive factor for banks.

Already, investors expect banks to comply with Basel III fully loaded Common Equity Tier 1 ratios of at least 10 to 12 percent, even though regulators require a minimum ratio of only 7 percent by 2019. Furthermore, investor focus has now shifted to compliance with leverage ratios. Minimum requirements in the range of 5 to 6 percent are expected, clearly driven by the U.S. and the UK, raising the bar in terms of capital levels.

We anticipate a similar development for liquidity ratios. Owing to central-bank intervention, investors have not yet considered this issue critical. While liquidity-coverage-ratio requirements have been finalized, the net stable funding ratio (NSFR) is still in debate. Despite doubts among some banks, we believe regulatory intent to oversee long-term bank liquidity is sufficiently strong to push implementation of the NSFR.

Financial-stability efforts will focus on global harmonization of diverse regulatory standards, such as leverage ratio rules, and on defining additional capital-related technical measures to deal with current regulations that are insufficient. As a start, market risk measurement of trading-book positions will be revised under the fundamental review of the trading book. Risk measurement of securitizations will also be revamped on the basis of the regulations for implementing Basel III's securitization framework.

EXHIBIT 3 | Regulatory Reforms Can Be Grouped into Three Broad Clusters

Financial stability

- Protection of the stability and integrity of the financial system
- Stricter capital requirements and more coherent risk measurement
- New requirements regarding leverage and liquidity
- Stricter requirements related to risk measurement in specific product classes (for example, trading-book instruments and securitizations)

Prudent operations

- Improvement of business conduct, governance, and procedural standards
- Increased consumer protection and clearer guidelines for trading
- Tighter compliance requirements and personal liability of executives and directors
- Stricter documentation and reporting requirements

Resolution and separation

- Ensuring the general resolvability of banks
- Development of a resolution model to avoid taxpayer-funded bailouts and to protect critical economic functions
- Increase of banks' loss-absorption capacity through cascading balance sheets and defined creditors sharing the costs of resolution (bail-ins)
- Separation as a measure for avoiding or simplifying a potential resolution

Source: BCG analysis.

Finally, it remains to be seen how global harmonization will be enforced. (See the sidebar “Demystifying the Transatlantic Debate: Is the Playing Field Level for U.S. and EU Banks?”) There are also questions related to the further development of Pillar 1 and Pillar 2 liquidity requirements and the degree to which they will match the development of capital standards.

Prudent Operations: Entering a New Game

In addition to establishing financial stability after the crisis, regulators have also focused on episodes of apparent misconduct. Abusive sales tactics, opaque fee structures, index rigging, and conflicts of interest have been among the most prominent targets of regulatory countermeasures to ensure prudent operations. Regulators have emphasized consumer protection and provided clear guidelines for trading, heightened compliance requirements, and tightened documentation and reporting requirements.

The most prominent regulations already in place include the markets in financial instruments directive and regulation (MiFID II/MiFIR) in the EU as well as the

Dodd-Frank Act's Title VII in the U.S. The European rules aim to harmonize the European financial markets and improve consumer protection. Among other requirements, they have defined transparency of electronic markets, including “dark pools.”¹ In the U.S., Title VII of Dodd-Frank creates a framework for the regulation of swap markets, for example, placing stricter requirements on clearing and trading OTC derivatives. Topics still under development include principles for effective risk-data aggregation and risk reporting, better known as BCBS 239, published by the Basel Committee on Banking Supervision.

In addition, the drastic enforcement of sanctions, the increased personal liability of “acting persons” (those actively involved in the business), and the partial criminal liability of executives and top management represent strong tightening of regulations. This part of the reform reflects regulators' intent to trigger a cultural change in banking, making banks more willing to act much more transparently and proactively vis-à-vis supervisory authorities and the market.

In summary, we believe that the target picture for prudent operations is clear from the viewpoint of regulators, and it is now up to

DEMYSTIFYING THE TRANSATLANTIC DEBATE

Is the Playing Field Level for U.S. and EU Banks?

Maintaining a level playing field—especially between the home markets of U.S. banks and their European counterparts—has long been a central argument against regulatory reform. Among the many approaches to this debate, we have chosen the leverage ratio and bank separation rules for a first and basic discussion of a level playing field on the group level.

Leverage Ratios

With Basel III, a global baseline for leverage has been introduced for the first time.¹ Increasingly, the ratio of Tier 1 capital to total exposure is considered a crucial regulatory tool, functioning as a backstop to risk-related measures.

Prior to Basel III, leverage measurement had been based largely on accounting numbers. Since U.S. accounting standards allowed for more favorable netting of derivatives than did International Financial Reporting Standards, U.S. banks were able to indicate higher leverage ratios. Also on a comparable basis, after accounting for this effect, U.S. banks historically showed higher leverage ratios than European banks.

This situation could have been the result of enhanced adaptation due to the historical use of leverage ratios, the decision not to adopt Basel II in the U.S., or the lower level

of bank debt on U.S. banks' balance sheets due to their stronger capital-market orientation.

Since the introduction of Basel III and the final proposals for the leverage ratio published by the Basel Committee, both U.S. and European banks seem set to apply the same leverage rules. However, the latest U.S. legislative update, the Enhanced Supplementary Leverage Ratio, introduced three major and potentially sizable differences:

- There are significantly higher minimum levels—5 to 6 percent compared with the Basel Committee's proposed 3 percent. In Europe, final minimum levels are not expected until 2017.
- The leverage ratio is to be calculated on the basis of 90-day daily exposure averages, while current drafts in Europe adhere to the Basel Committee's standard, based on the average of three month-end exposures.
- The leverage ratio is part of the regular U.S. stress-testing exercise with minimum levels of 3 to 4 percent under stress. In Europe, no such requirement is planned yet.

On the basis of this current state of leverage rules, it can be debated whether

the banks to implement it and especially to control themselves.

Resolution and Separation: First Steps Toward Resolvability

Although regulations governing financial stability and prudent operations are largely established, resolution and separation reforms are still on the table and yet to be implemented.

Among the central goals of postcrisis reforms are achieving ways to protect functions criti-

cal to the real economy and avoiding any need for future taxpayer-funded bailouts. But if a bank were to fail today, taxpayers' money would be at risk: the regulatory intent has not yet been achieved.

However, some elements of resolution have progressed, especially in the U.S. and Europe.

Financial-Stability Reforms Related to Resolution. Capital surcharges as well as cascading balance sheets through bail-in rules are about to go into effect despite continuing discussion regarding the absolute level of

U.S. banks will be at a disadvantage relative to European banks.

Bank Separation

Unlike Europe, the U.S. has no comprehensive separation initiatives on the table. Instead, the U.S. has three sets of regulations, which, together, affect separation.

The recently adopted Volcker Rule bans proprietary trading and funds sponsorship, while the so-called swap-push-out rule requires banks to spin off specific speculative derivatives businesses into separate entities. These two measures are supported by the broker-dealer requirements embedded in the Securities Exchange Act of 1934, which requires banks to set up separate entities for specific trading activities.

In theory, the broker-dealer requirements allow specific trading activities to remain in the core bank. In practice, the decision whether to place these activities in the core bank or with the broker-dealer is product specific. For example, the placement of derivatives business in the core bank could be debated for practical reasons.

In Europe, several national separation laws are already in force. These require only the separation of a bank's high-risk activities from its deposit-taking activities, and could, therefore, be considered less strict than the

U.S. regime. In contrast, the EU separation proposal intends to ban proprietary trading and fund sponsorship and is analogous to the U.S. Volcker Rule. Moreover, the regulator has been granted leeway to demand separation of other risky trading activities such as market making. Depending on the regulator's discretion, this could result in separation that is higher or lower than that of the U.S. regime.

Although the combined U.S. regime once appeared stricter than Europe's individual national initiatives, it is debatable whether post-Barnier separation regimes will establish a level playing field. Still, conclusions need to be made very specifically on the basis of individual banks' business models and product offerings. The same message holds true when taking the UK's Vickers approach into consideration.

Besides these regulatory issues, other potential distortions to a level playing field include restrictions on bank operations on a regional rather than group level and such market-related concerns as discrepancies in banks' earning capacity and funding advantage. These issues merit demystifying in a future assessment.

NOTE

1. Prior to Basel III, only Switzerland, Canada, and the U.S. used stand-alone leverage-ratio limits.

minimum requirements (such as potential Pillar 1 total-loss-absorption capacity). The issue of interconnectedness has also been addressed. Large exposure limits for intragroup lending will reduce interconnectedness among legal entities of one and the same banking group. Interconnectedness with other banks stems mainly from derivatives and interbank lending. The former has been addressed by the adoption of clearing obligations for standardized derivatives through central counterparties and the capital disincentives for noncleared derivatives. Capital disincentives also constitute the main step

toward reducing interdependencies with the latter.

Resolving interconnectedness with nonbanks has, so far, made the least progress, but it remains high on regulators' monitoring list, with the intention to use limits as the potential means of resolving this issue.

Prudent Reforms in Operations Related to Resolution. The BCBS 239 principles for risk data aggregation and reporting, when complete, will, from a regulatory standpoint, constitute a major contribution to enhancing

banks' resolvability, because the principles increase transparency of individual portfolios. Transparency is achieved by improving banks' ability to aggregate and report risk data accurately, comprehensively, and in a timely fashion.

A complex regulatory landscape is not the only hurdle to creating and harmonizing resolution measures. The diversity of the global banking industry also imposes substantial difficulties. Resolution mechanisms must be designed to function in emergency circumstances while taking into account a multitude of business models and fundamentally different yield-risk profiles and refinancing costs.

While banks have already been required to design their own recovery and resolution plans, these "living wills" have, in many cases, been part of the problem rather than the solution. To date, they have largely failed to provide regulators with the transparency and trustworthiness required to resolve large cross-border banks and protect crucial economic functions. Instead, they have been plagued by unrealistic and inadequately supported assumptions, regarding, for example, the behavior of counterparties, investors, and central counterparties. Living wills have also failed to identify the changes in bank structure and practices that would be needed to enhance prospects for orderly resolution.

As a consequence, the discussion of structural bank reforms as a means of reducing complexity and protecting the economy is a growing priority. On the national level, an array of initiatives has already come into effect, with the U.S., the UK, and Switzerland being the most advanced. (See Exhibit 4.)

Next steps by U.S. regulators—which allowed the living wills of several major banks to fail—are eagerly awaited, as are changes to the EU's separation proposal and G20 endorsements from the leaders' summit in Brisbane.

THERE is still a long way to go to achieve regulators' intents for resolution and separation. First, the implementation of all measures created to date must be ensured and their effectiveness monitored. Many of the measures exist only on paper, thus the effectiveness of their incentives has yet to be proved in practice. Furthermore, there are outstanding cross-border issues yet to be addressed. These include selective collaboration agreements, as well as the alignment of regulators on a global resolution framework and global standards, such as for derivatives contracts.

In day-to-day commerce and transactions, regulators face the task of monitoring the effectiveness of the changes in culture and incentives that they have imposed on banks. And, finally, the topic of separation as a means of complexity reduction is likely to persist. Further progress toward that goal, both regional and global, remains to be seen.

NOTE

1. "Dark pools" are private exchanges, not accessible to the investing public, for trading securities.

EXHIBIT 4 | Several Separation Initiatives Are in Effect at the National Level While Uncertainty Remains at the EU Level

		Scope	2010	2011	2012	2013	2014
Europe	EU  Liikanen report; Barnier proposal	Prohibition of proprietary trading and fund sponsorship; separation of trading activities upon assessment			<ul style="list-style-type: none"> October 2012 Liikanen report published 		<ul style="list-style-type: none"> January 2014 Barnier proposal on EU banking-structure reform published
	Germany  German bank-separation law (Schäuble)	Separation of proprietary trading and prime-brokerage lending and trading activities upon assessment				<ul style="list-style-type: none"> February 2013 Draft published June 2013 Enactment August 2013 In effect 	
	France  French bank-separation law (Moscovici)	Separation of proprietary trading			<ul style="list-style-type: none"> December 2012 Draft published 	<ul style="list-style-type: none"> July 2013 Enactment 	<ul style="list-style-type: none"> July 2014 In effect
	UK  UK bank-separation law (Vickers)	Separation of the retail small- and midsize-enterprise activities from the rest of the group		<ul style="list-style-type: none"> September 2011 Vickers report and recommendations published 	<ul style="list-style-type: none"> December 2012 Parliament report published, affirming Vickers's recommendations 	<ul style="list-style-type: none"> December 2013 Enactment 	<ul style="list-style-type: none"> March 2014 In effect
	Switzerland  Swiss too-big-to-fail law	Resolvability of systemically important financial institutions	<ul style="list-style-type: none"> October 2010 Too-big-to-fail report published December 2010 Too-big-to-fail proposal published 	<ul style="list-style-type: none"> September 2011 Enactment 	<ul style="list-style-type: none"> March 2012 In effect 		
U.S.	U.S.  Dodd-Frank Volcker rule ²	Prohibition of proprietary trading and fund sponsorship	<ul style="list-style-type: none"> July 2010 Enactment¹ 				<ul style="list-style-type: none"> January 2014 Final rule published April 2014 In effect
	U.S.  Dodd-Frank swap-push-out rule ²	Separation of specific risky derivatives business from the rest of the group	<ul style="list-style-type: none"> July 2010 Enactment¹ 			<ul style="list-style-type: none"> December 2013 Final rule published 	<ul style="list-style-type: none"> January 2014 In effect
	U.S.  Dodd-Frank enhanced prudential standards for foreign banking organizations	Requirement to build fully U.S.-regulated U.S. subgroups for foreign banks			<ul style="list-style-type: none"> December 2012 Draft published 		<ul style="list-style-type: none"> February 2014 Enactment

Preenactment
 Postenactment

Source: BCG analysis.

¹Dodd-Frank has been enacted, but implementation rules have not yet been determined.

²The Securities Exchange Act of 1934 requires placement of specific trading activities into a separate broker-dealer entity.

SHIFTING THE MIND-SET TO TRANSPARENCY

THE BANKING SECTOR IS becoming a comprehensively regulated industry. This is not a onetime phenomenon. Instead, a new era has begun.

In the face of these circumstances, we believe, banks need a shift in mind-set. Regulation will not go away. Instead, banks must adopt a good-citizen approach to proactively addressing the broad intent of regulation.

This will demand a structural assessment of regulatory measures and a regulatory-target picture to identify the pressure points in a bank's current setup. Using this approach, clear management options can be deduced and a regulatory roadmap designed.

Managing the Transition

This transition can be supported by establishing forward-looking management of the regulatory-project portfolio and putting in place a comprehensive control framework.

Three major steps help operationalize the management of the regulatory-project portfolio:

- Establishing a regulatory and findings baseline as a yardstick is crucial. This baseline should be comprehensive and forward-looking, enabling the bank to maintain a multiyear perspective.

- The bank should design and prioritize implementation measures in a way that links topics, content maturity, and minimum implementation time. This will require leading discussions about fundamental solutions. Mere fire fighting will not sustainably resolve the urgent issues of the new era.
- The budget demands of proposed implementation packages must be challenged on the basis of a predefined set of eligible reduction levers—for example, reducing the scope of bank activities, requirements, and obligations—and price reduction.

In order to ensure that all existing and new regulations and internal policies are strictly followed, banks should establish a comprehensive control framework based on the three-lines-of-defense (3LOD) model, which consists of business support, independent controls, and internal audit. This approach is crucial for reducing nonfinancial risks such as fraud, misconduct, and reputational damage, which, in most cases, have not been sufficiently considered. (See the sidebar “Litigation: The New Cost of Doing Business.”)

In order to derive a state-of-the-art 3LOD model, banks have to fundamentally upgrade their control frameworks:

LITIGATION

The New Cost of Doing Business

The new era in banking is characterized by a rigorous enforcement of sanctions. As of September 2014, the cumulative litigation costs for EU and U.S. banks since the onset of the financial crisis had reached some \$178 billion. (See the exhibit below.)

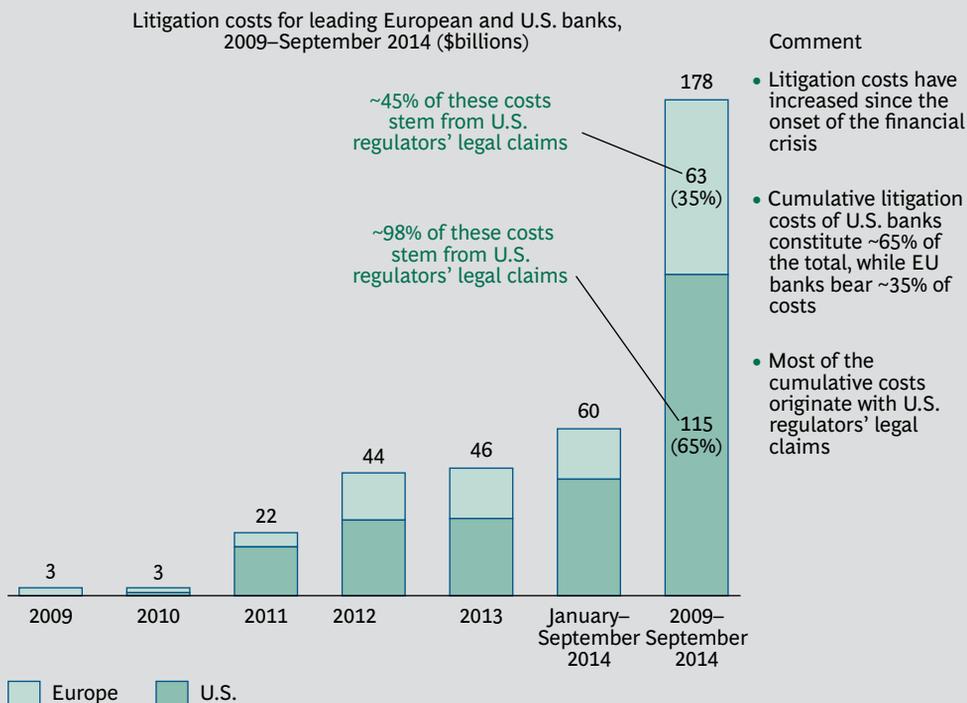
Most of the costs originated with U.S. regulators' mortgage-related claims, and the remaining litigation costs are divided among claims focused on misselling, violations of U.S. sanctions, improper conduct, market manipulation, tax evasion, and misrepresentation. Litigation costs of banks headquartered in the U.S. leapt higher in 2011, driven by mortgage-related claims, which continue to dominate. EU bank costs were kick-started in 2012, beginning with redress payments for

misselling payment protection insurance in the UK, followed by market manipulation issues—for example, those related to the London Interbank Offered Rate scandal—as well as improper-conduct litigation, such as anti-money-laundering cases.

The current wave of litigation cases has not yet been settled, and potential—still hidden—litigation risks are substantial. Meanwhile, regulators have shifted their view toward more unified and sanction-based supervision, adopting regulations with a stronger focus on business conduct.

All of these developments reflect the persistent character and future burden of litigation—a new cost of doing business.

Postcrisis Legal Claims Are Rising Steadily and Must Now Be Considered a Cost of Doing Business



Source: BCG analysis.

Note: The peer group covers 6 leading U.S. banks (Bank of America, JPMorgan Chase, Citigroup, Morgan Stanley, Wells Fargo, and Goldman Sachs) and 12 leading EU banks (BNP Paribas, Credit Suisse, Deutsche Bank, UBS, HSBC, Barclays, The Royal Bank of Scotland, Rabobank, Lloyds Bank, Standard Chartered, ING, and Banco Santander); data is classified on the basis of headquarters locations and includes only fines and settlements exceeding \$50 million.

- Banks need to establish a comprehensive, up-to-date risk inventory reflecting all regulatory, business-conduct, and stakeholder requirements and clearly allocate responsibilities within the first and second lines of defense.
- Furthermore, the second line is responsible for defining a global control framework, specifying how best to adapt global standards to local needs and how to achieve a well-balanced, effective control intensity.
- On the basis of this global control framework, the first line of defense can build specific controls, driving the full integration into the bank's operating model.

A foundation has to be in place for risk data aggregation and reporting.

Although comprehensiveness and rigor are crucial, a pragmatic approach to implementation is typically even more important to success. This includes identifying the most important controls through group-wide risk-assessment standards, ensuring action-promoting outcomes of controls with a proper reporting framework, and reviewing the effectiveness of controls on a regular basis.

Enhancing Data and IT Capabilities

In this new reality, a major regulatory goal is the improvement of banks' data and IT capabilities in order to ensure higher transparency levels and enhanced reporting within the industry.

To date, regulators have already pursued a variety of related measures, including in Europe the introduction of Common Reporting and Financial Reporting—harmonized reporting standards—by the European Banking Authority (EBA), the execution of the ECB's Asset Quality Review (AQR) and the EBA's EU-wide stress test, as well as the new and

significant requirements of the ECB's Ana-Credit and the European supervisory authorities' Supervisory Review and Evaluation Process.

While many of these regulations are intended to cover specific reporting, the BCBS 239 regulatory requirements constitute the overall umbrella. BCBS 239, published in January 2013, requires so-called global systemically important banks to comply with 14 principles by January 1, 2016.

A foundation has to be in place for risk data aggregation and reporting within banks:

- First, the required scope of reporting needs to be clearly defined and critically assessed. It should cover at least all risk reporting but may additionally cover all main types of reporting. On the basis of these, a comprehensive map should be created to identify the critical metrics needed to address existing and future regulation.
- Next, full transparency on the aggregation of specific critical metrics and their components, based on the map, should be established functionally, technically, and in terms of bank processes.
- Furthermore, data quality and data governance should be ensured. On the basis of the fully transparent decomposition of critical metrics, the bank can assign clear responsibility to components. Thus, data quality can be measured and tracked, leading to enhanced data-quality management.
- Finally, overall data quality and consistency of components used in reporting should be guaranteed on the basis of an overarching control framework.

With the basic foundation in place, data delivery capabilities must now be enhanced, raising several management options that need to be addressed. These include timelier reporting, a single-point-of-truth data infrastructure with the necessary data granularity and cross-functional data alignment, as well as enhanced automation.

An Opportunity, Not a “Necessary Evil”

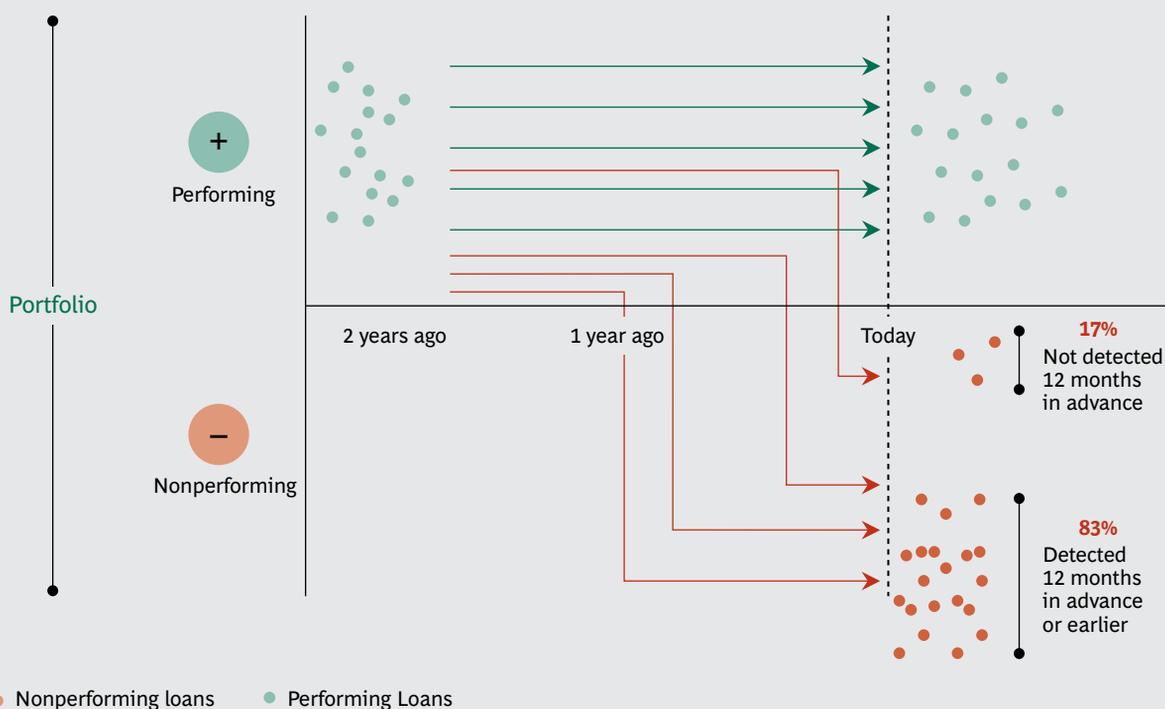
Given the expected pressure on the data and IT side to push transparency, banks could easily find themselves thinking about these as a necessary evil. However, that perspective fails to recognize the positive benefits that a transparent bank enjoys. For instance, better data and IT capabilities enhance quantitative analyses that help accelerate decision processes and make them more objective. One approach developed by BCG’s risk-analytics team involves setting up an early-warning scoring system to help detect credit events. BCG analyses show that early-warning scoring systems could have identified more than 80 percent of today’s defaults a year in advance. (See Exhibit 5.)

Furthermore, we expect a second-order effect of this push for transparency: the reappearance of M&A on the agenda. Especially in Europe—where the ECB’s AQR and stress tests bring an unparalleled transparency to banks’ balance sheets and capital situation—opportunities for portfolio deals or even full-scale cross-border and in-market M&A will arise.

WHICHEVER approach a bank chooses, one thing is clear: each institution must find its own path to prevail in this era of relentless regulatory oversight, new standards of conduct, and rigorous enforcement. Success will require banks to redefine the very nature of risk, to move beyond their current control frameworks, and to embed new compliance thinking and systems into their operating model.

Total transparency is not just a mantra or marketing catchphrase for banks. Nor is it simply a new set of legal obligations and constraints. It will be a permanent and defining characteristic of banking institutions on the leading edge of change. Winning banks will be those that translate regulatory requirement and investment into strategic opportunity and commercial advantage. Navigating the new environment may demand nerves of steel. It will certainly require building transparent banks.

EXHIBIT 5 | An Early-Warning Scoring System Could Have Identified 83 Percent of Today’s Defaults 12 Months Ago



Source: BCG analysis.

FOR FURTHER READING

The Boston Consulting Group has published other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here.

Global Asset Management 2014: Steering the Course to Growth

A report by The Boston Consulting Group, July 2014

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Global Risk 2013–2014: Breaching the Next Banking Barrier

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Global Payments 2013: Getting Business Models and Execution Right

A report by The Boston Consulting Group, September 2013

Risk Report 2012–2013: An Inflection Point in Global Banking

A report by The Boston Consulting Group, December 2012

NOTE TO THE READER

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