Global Regulatory Network

Should structure shape strategy?

Steps banks need to take in response to structural reform

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Ordinarily structure should follow strategy. That's not so for banks. For banks, structure shapes strategy, and regulation shapes structure. So, ultimately, regulation circumscribes the strategy a bank can choose to follow and prescribes how the bank should implement its strategy.

To enhance financial stability, policymakers in key jurisdictions are reforming regulations concerning how banking organizations should structure themselves. This certainly poses a challenge to banks. But in our view, it can also represent an opportunity for a bank to make its business model simpler and more efficient so that it can deal with the greater competition that is growing daily. This note explains the structural reforms that are in place or on the horizon. It then outlines the steps that banks can take not only to meet the challenge but to seize the opportunity.

Structural reform

Prior to the financial crisis, policymakers took a global, consolidated approach to regulation and supervision. Essentially, supervisors viewed the banking group as a single entity under the oversight of its home country supervisor. That prompted supervisors to allow banking groups to run themselves on global business lines, as if they were a single legal entity.

The crisis ended that approach. Implicit government support became explicit. Taxpayers, rather than investors, bore the cost of bank failures. That proved deeply unpopular with voters, and policymakers concluded that "too big to fail" was too costly to continue.

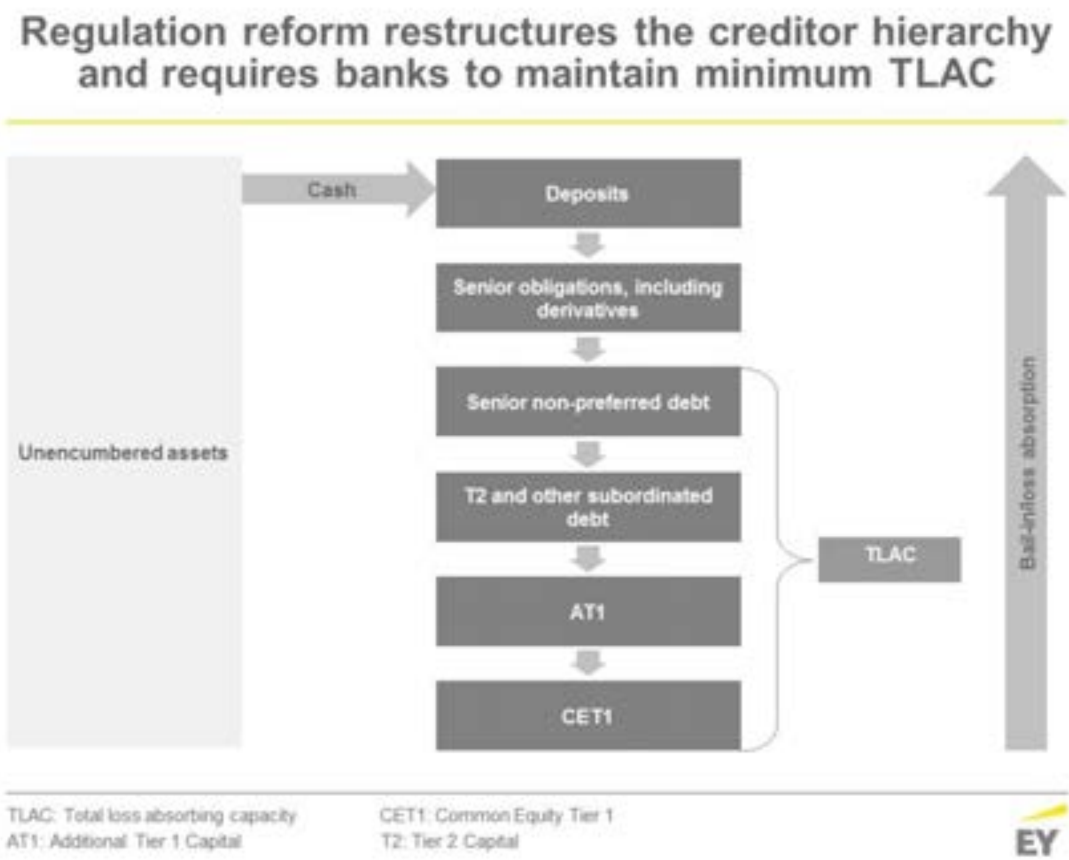
Structural reform then appeared on the regulatory agenda. Policymakers moved away from the consolidated approach and differentiated much more sharply between the bank and the overall banking group. The new approach aims to make banks both less likely to fail as well as "safe to fail," so that they can be resolved (if they do fail) without taxpayer support, interruption in critical economic functions or significant disruption to financial markets or the economy at large. Structural reform thus complements other elements of the overall reform program, such as increased capital and liquidity requirements, improved governance, better risk management and greater resolvability.

Building a better working world

Structural reform principally encompasses three areas. The first is capital structure, especially at the bank level. Jurisdictions are reordering the bank's creditor hierarchy and introducing a significant amount of "gone concern capital" into that hierarchy. The second is activity restrictions, especially at the bank level, particularly where the bank issues insured deposits to individuals and small to medium-sized enterprises (SMEs). The third is the group's legal entity structure. Jurisdictions are reconsidering what affiliates a bank should be permitted to have and whether these should be subsidiaries of the bank or "sister" affiliates of the bank, so that both the bank and the affiliates are "daughters" of a common parent holding company.

Capital structure

Making banks resolvable is central to the G-20 reform program. To help achieve this end, legislation and regulation require systemic banks to put in place a capital structure that will allow the resolution authority — if a bank reaches the point of non-viability — to have investors rather than taxpayers recapitalize the bank quickly so that it can continue to perform critical economic functions. This avoids having to liquidate the bank or subject the bank to insolvency proceedings. That in turn should minimize disruption to financial markets and the economy at large.



The mechanism to do this at the bank level is bail-in. This allows the resolution authority to write down a bank's unsecured liabilities or convert them into equity as soon as the bank enters resolution. New rules regarding the hierarchy of the bank's creditors determine the order in which liabilities will be subjected to bail-in. In general, these rules require investors to go first and depositors to go last.

To be sure that "investor" liabilities are sufficient to recapitalize the failed bank, jurisdictions require global systemically important banks to maintain a total loss absorbing capacity (TLAC) equal to 18% of its risk-weighted assets.[1] At least one-third of this must be in the form of "gone-concern" capital (additional Tier 1 and Tier 2 capital plus senior "non-preferred" debt.) That is intended to be the primary source of investor funds for the bank's recapitalization (but not necessarily the only one, as bail-in need not stop at TLAC but can extend all the way up the creditor hierarchy). If the write-down or conversion of such gone-concern capital is sufficient to recapitalize the bank, customer obligations such as deposits and derivatives can remain intact.

However, it should be stressed that although TLAC and bail-in are necessary to achieve resolvability, they are not sufficient. Measures also need to be taken to ensure that the recapitalized bank has uninterrupted access to adequate liquidity, to financial market infrastructures and to critical services contracted from affiliates and third-party providers. Finally, if the failing bank is part of a broader banking group, resolution at the bank level has to be coordinated among relevant home and host authorities as well as take into account the implications for the bank's affiliates, subsidiaries and parent holding company, including the possibility that the parent holding company may be subject to normal bankruptcy proceedings.

Activity restrictions

Regulation determines the activities in which a bank may engage, either directly or via affiliates, within a broader banking group. By limiting these activities, regulation aims to limit the risk that banks can take, so that banks are less likely to fail, as well as to reduce the interconnections among banks so as to limit contagion if a bank does fail. In response to the financial crisis, these activity restrictions have increased, for the group overall and at the bank level.

[1] *Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution*, Financial Stability Board, 2015.

Mandatory clearing

To reduce interconnectedness among banks, the G-20 reform program mandated that standard derivatives be cleared via central counterparties (CCPs) rather than bilaterally. The authorities then developed standards so that systemic CCPs remain resilient (able to withstand simultaneous failure of their two largest participants) and resolvable. For exposures to "qualifying" CCPs that met these standards, banks would have lower capital requirements.

This is the case, provided, of course, that the bank's home jurisdiction "recognizes" the CCP. This is straightforward if the CCP is in the same jurisdiction as the bank but more complex if the jurisdiction of the bank counterparty differs from that of the CCP. It has taken the better part of a decade for the US and the European Union (EU) to work out how CCPs registered in one jurisdiction can be recognized for use by counterparties located in the other.[2]

But there is no guarantee that this approach will apply to UK CCPs once the UK leaves the EU. Nor is there any guarantee that the EU will recognize UK CCPs (indeed, the European Commission is proposing that euro-denominated instruments be cleared in the Eurozone). Continued recognition by the US and the EU will require separate negotiation and confirmation — yet another repercussion of Brexit (see below).

Aside from mandatory clearing for standard derivatives (see box above), the most common revision is some form of restriction on proprietary trading. The US led the way with the inclusion of the Volcker Rule in the Dodd-Frank Act. But even those who concur with the view that proprietary trading should be banned agree that the rule — all 962 pages of it — is complex, confusing and costly. Indeed, some have suggested that the costs of the rule outweigh the benefits. In its recent report to the President on the regulation of banks and credit unions, the US Treasury, as expected, recommended revisions to the Volcker Rule that would decrease the scope of its application and simplify some of its mechanics to lessen the compliance burden and remove some of the restrictions on market-making and hedging activity.[3]

Although the European Commission has proposed a common approach to dealing with the issue of proprietary trading,[4] to date, national governments have each set their own rules. Germany and France have each limited the ability of banks headquartered in their respective countries to engage in such trading and/or have forced banks to put such trading into separate subsidiaries. But as yet there has been no fundamental revision to the EU banking charter — this remains a universal bank.

[2] The common approach effectively provides "No-Action Relief for EU-Based Registered Derivatives Clearing Organizations that are Authorized to Operate in the European Union, from Certain Requirements under Part 22 and Part 39 of Commission Regulations" that requires non-US CCPs that wish to clear security futures traded on US exchanges to register with the US Commodity Futures Trading Commission (CFTC) and adhere to relevant CFTC rules.

[3] *A Financial System That Creates Economic Opportunities For Banks and Credit Unions*, US Department of the Treasury, 2017.

[4] *Proposal on structural measures improving the resilience of EU credit institutions*, European Commission, 2014.

In contrast, both the UK and Switzerland have made fundamental changes to the banking license. They have effectively created two different types of bank, a "ring-fenced" bank (RFB) and "non-ring fenced" bank (NRFB). In each jurisdiction, the largest banks have to split themselves in two as well as create a "ring-fence" around the RFB. This process is already complete in Switzerland and must be finished by 1 January 2019 in the UK.

In the UK, banking "core" deposits (insured deposits held by individuals and SMEs) must go in the RFB. Certain activities (e.g., dealing in securities and derivatives, having "foreign" branches) under the general banking license are "prohibited" for the RFB. The rest are "permitted" for the RFB. Thus, the RFB takes core deposits and engages only in permitted activities; the NRFB may engage in the full range of banking activities but may not take core deposits.

The ring-fence restricts the ability of the RFB to transact or interact with the NRFB, the parent holding company and other affiliates within the group. The restrictions include limitations/prohibitions on lending to affiliates, obtaining services from certain affiliates, investing in subsidiaries and/or paying dividends or making distributions to parent company/shareholders. Governance arrangements (e.g., restrictions on management or director interlocks) reinforce these restrictions so that the RFB is "independent" from the rest of group and insulated from the risks taken by its affiliates.

There are many ways to comply with these requirements. In fact, banks have to make a choice about their business model, and this poses an opportunity to sharpen the group's strategy and improve its efficiency (see below).

Legal entity structure

The third element of structural reform concerns the overall structure of a banking group. The focus is on changes that promise to improve resolvability. The key questions are whether the top-level company in a banking group should be a holding company rather than an operating bank, how a banking group's operations should be organized, and the degree to which each of the entities within a banking group should focus on a particular line of business.

At a banking group, the top-level parent company can either be an operating bank or a holding company. Universal bank jurisdictions (e.g., France, Germany) tend to favor the former. Jurisdictions that require banks to conduct some activities via affiliates favor the latter, as this reinforces the independence of the insured depository institution (in the case of the United States) or the ring-fenced bank (in the case of the UK or Switzerland).

From a resolution perspective, both structures work. If the operating bank is the parent company, it issues TLAC instruments directly to external investors. If the bank reaches the point of non-viability the "gone-concern" elements are written down or converted to equity to recapitalize the bank. If the parent is a holding company, the subsidiary bank(s) issue TLAC instruments to the parent (internal TLAC), and the parent holding company issues TLAC instruments to third-party investors (external TLAC). In the event that the subsidiary bank reaches the point of non-viability, conversion or write-down of the "gone-concern" elements of TLAC effectively recapitalize the bank and pass the losses up to the parent holding company.

A second issue concerns how a banking group should organize its activities outside its home country. This requires agreement between home and host jurisdictions. If the home country permits its banks to sell services directly to foreign customers on a cross-border basis or to have branches, subsidiaries and/or affiliates in other countries, host countries have the final say on the organizational form the bank must use.

Subsidiaries offer host countries more direct control than branches. The former are incorporated in the host country, and the primary supervisor is the host country authority. In contrast, branches are an integral part of the parent bank, and the primary supervisor is the home country authority. Consequently, host countries

have a fairly strong preference for subsidiaries, especially where the "foreign" banking organization serves individuals and/or SMEs.

To gain control and exercise oversight over all of a foreign banking organization's subsidiaries operating in the US, the Federal Reserve Board issued and implemented a regulation requiring foreign banking organizations to place such subsidiaries into an intermediate holding company (IHC).[5] The IHC is regulated and supervised as a US bank holding company according to enhanced prudential standards applicable to such entities. The EU is now considering imposing a similar requirement, namely that third-country institutions group their subsidiaries within the EU under a single intermediate parent undertaking (IPU).[6] As currently proposed, this would create significant conflicts for US groups. Under US law, they need two IPUs (one for banking and one for securities), but the EU may find itself hard-pressed to accommodate such a change, as the securities IPU would not be subject to the same degree of Eurozone supervision as that provided to banks by the European Central Bank under the Single Supervisory Mechanism.

Finally, there is the question of alignment: should a legal vehicle focus on a particular line of business or house many; should a business line use predominantly one legal vehicle or be stretched across many? At a minimum, banking groups have to create a map detailing the activities conducted in each vehicle and the vehicles that each activity employs. In their resolvability assessments, authorities increasingly express a preference for more complete alignment, namely separately capitalized subsidiaries that are principally engaged in a single line of business. Focusing the subsidiary on a particular line of business provides greater optionality for resolution authorities and simplifies the restructuring of the failed bank as such subsidiaries can be detached and transferred to a third party via a sale of the subsidiary's common equity. Focusing subsidiaries also reduces integration costs facing prospective buyers and therefore widens the scope of prospective buyers. This raises the price and/or accelerates the completion of a prospective sale. These results enhance recovery and facilitate resolution.

To further enhance resolvability, authorities are encouraging banking groups to establish separately capitalized service companies that can keep the bank's critical services running even if the bank enters resolution. Such service companies should also, where possible, contract on behalf of the group with third-party service providers and bind such providers to continue to deliver services to a bank in resolution. This promotes operational continuity in resolution.

But perhaps the most important alignment question concerns that of the group's parent company. If this is a holding company rather than an operating bank, policymakers argue that it should be a "clean" holding company, restricted to investments in subsidiaries and holdings of certain investments. The parent should not receive or grant guarantees.

This structure may simplify the resolution of the parent holding company, but it also changes the focus of group management, particularly where the relevant authorities insist that particular subsidiaries (such as the UK ring-fenced bank or the US IHC) be "independent" from the parent and other affiliates within the group. Taken to the limit, the clean holding company approach tilts the task of its executives toward managing the parent's investments in its subsidiaries rather than running the bank or its affiliates.

[5] Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 2014.
[6] Capital Requirements Regulation II, 2016.

Reform is likely to continue

This already very complex picture is about to become even more so. The US is reviewing Dodd-Frank. The UK will leave the EU (see box). The EU is considering how to complete the Banking Union. All these developments will impact what banking groups can do as well as where and how they can do it. In other words, structural reform is unlikely to stand still.

Brexit

The UK decision to leave the EU (Brexit) will affect the ability of entities located in the UK to serve clients located in the 27 Member States remaining in the EU as well as the ability of EU 27 firms to serve clients in the UK. The exact details remain the subject of negotiation, but it is already certain that banks cannot continue to operate in Europe as they do today.

By the second quarter of 2019, the UK is likely to become a third country outside the single market. As a result, entities in the UK will no longer enjoy the freedom to market their services directly to individuals and institutions in other Member States. UK firms will no longer enjoy the automatic right to establish branches or subsidiaries in other Member States, and firms from the EU 27 will lose the same rights to do so in the UK. Indeed, it is entirely possible that authorities on each side of the Channel will insist that existing branches be reauthorized. International agreements between the EU and third countries such as the US may no longer apply to the UK once the UK leaves the EU. Finally, qualified staff are likely to find it more difficult to cross borders to live and work. As a consequence, banks doing business in the EU will have to rethink and restructure their European operations.

Opportunity as well as challenge

As this brief outline demonstrates, structural reform poses quite a challenge for banks. We think it also presents banks with a significant opportunity, namely to rethink whom the bank wants to serve, what the bank wants to do, as well as where and how it wants to do it. Although regulation is constraining the answers to these questions, technology is opening new possibilities to reduce cost, improve service quality, enhance customer experience, increase compliance and make risk management more precise. This can strengthen the bank's business model as well as improve disclosure to supervisors, investors and the public at large.

Therefore, banking organizations should respond to structural reform with a view toward the business they would like to become, rather than the businesses in which they currently engage. The desired or required operational "end" state is very likely to differ markedly from the group's current configuration. Moving to the new configuration is a massive, complex exercise in dynamic project management that involves practically every aspect of the firm's operation (including, without limitation, governance, risk management, capital, liquidity, technology, tax, remuneration and recruiting). It is a program of change that has to be executed alongside and in conjunction with projects to respond to other regulatory demands and to improve efficiency. In addition, the program needs to take into account that the desired configuration may evolve in response to broader political events and to further developments in regulation and/or technology. This reinforces the need for banks to become more transparent, flexible and agile, using digitization to put the organization on a "modular" basis so that it can accelerate the changes it may need to make to remain competitive. Finally, all this needs to be done while the bank continues to operate day in and day out.

The bank should start with a strategic review: what businesses will it be able to be in? Which ones does it want to be in? How do these compare with the bank's current businesses? How could such a combination of businesses be run and funded? How would such a combination appeal to investors? That comparison will

result in a stay-or-leave decision for each of the bank's current businesses as well as a decision about whether to enter one or more new businesses.

The next step is a vehicle check. What characteristics do the group's legal entities need to have to enable the bank to conduct the businesses selected by the strategy (see box)? Do the current vehicles have these attributes?

Vehicle check

A banking group must execute its strategy through specific legal vehicles. These in turn must have the attributes necessary to support the businesses in which the banking group would like to engage. These attributes include:

1. The ability to conduct the business. Does the entity's license permit it to conduct the business? If so, can the entity access the clients the banking group wishes to target? If it can, can the target clients deal with the vehicle?
2. The capacity to conduct the business. Some businesses and business models (e.g., corporate lending) may require the banking group to take large exposures to individual clients. This sets a floor on the individual and aggregate large-exposure limits that the entity will need, and that in turn sets a lower band on the amount of capital the entity will be required to have.
3. The ability to manage the vehicle. Can the group simply apply its global standards, or must it make adjustments to governance, risk management, recruitment, remuneration and/or other areas in order to conform to local standards or achieve some degree of "independence"? Must the vehicle do everything itself, or can it outsource specific functions to affiliates and/or third parties? Will the vehicle have access to relevant financial market infrastructures?
4. The ability to fund the vehicle. Can the vehicle issue the requisite range of liabilities (e.g., deposits, derivatives, senior debt, subordinated debt) in sufficient amounts and at acceptable cost? To what extent will clients, counterparties and investors require the vehicle to have its own credit rating? If so, does the vehicle exhibit the necessary characteristics (capital, liquidity, governance, etc.) to merit the rating that third parties expect? Will the vehicle have access to central bank facilities? Can the vehicle lend to or borrow from other affiliates within the group?
5. The ability to realize returns from the vehicle. What fees or taxes will the vehicle have to pay, including without limitation, taxes on income, turnover (value-added tax (VAT)), wages (employer contribution to social security) or liabilities (e.g., deposit insurance premiums, bank levy)? Can the vehicle pay dividends or make distributions to its shareholders? If so, do such actions require prior approval of the vehicle's supervisor? Conversely, will the group be required to act as a source of strength for the vehicle, or is its liability limited to the amount of its current investment?
6. The ability to fit the vehicles together into a cohesive whole. Do the vehicles in aggregate permit the group to comply with regulation and implement its overall strategy? How sensitive is this result to changes in the rules governing significant vehicles within the group?

On the basis of this review, the banking group should choose the combination of businesses and configuration of vehicles that is most efficient, taking into account likely future developments in regulation and technology as well as any costs of transition from the current structure to the new, including any tax aspects (see box).

Tax aspects

By definition, taxes are jurisdictional and levied upon legal entities. Therefore the increased regulatory focus upon legal entities will lead to a greater alignment between regulation and tax.

However, navigating the transition to a new structure will be complex: changing the group's legal vehicle structure may trigger taxes for the group and possibly for its clients. It may also require the group to plan anew with respect to income, VAT and withholding taxes, and bank-specific levies (for instance in the UK, there is a supplementary charge on bank profits, a restriction on the use of financial-crisis tax losses, a denial of deductions for compensation payments made by banks, and specific rules for tax-deductible additional Tier 1 and Tier 2 capital).

More broadly banks need to address the many detailed changes arising from the Organisation for Economic Co-operation and Development's (OECD) base erosion and profit shifting project, many of which have direct impact on structuring decisions, for instance revised definitions on creating taxable permanent establishments. This project still threatens to restrict tax relief for interest payments for banks, potentially affecting capital-raising plans. As well changing primary rules, governments themselves have transformed the way in which they administer taxes, particularly investing in the capacity to absorb and interrogate large volumes of data. This will allow many tax authorities to use powerful data analytics to check areas of tax, such as VAT and transfer pricing as well as tax reporting by clients (e.g., Foreign Account Tax Compliance Act).

For each of the bank's current vehicles this implies a "keep or kill" decision. If the decision is to "kill," should it be sold, spun off or wound down? If the bank needs to create a new vehicle, should it build one or buy one, on its own or in alliance with others?

The reviews outlined above should lead to a transition plan from the current configuration of businesses and vehicles to the desired configuration. This plan should take into account any necessary sequencing of actions as well as risk of execution so that the group can meet mandatory regulatory deadlines while continuing to operate on an ongoing basis. Last, but by no means least, communication — to staff, clients, supervisors and investors — should figure prominently in any transition plan. Timely and appropriate disclosure is especially important in connection with any issuance of TLAC instruments.

In sum, banks have no choice about whether or when to comply with structural reform requirements. They do have a choice about how.

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