Tackling the 'Too Big to Fail' problem

Connected Banking

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Accuracy's UK Banking practice welcomes you to the Connected Banking thought leadership series.

Why Connected Banking?

Banks have been always connected. And today more than ever, banks cannot operate in isolation. In a fast-moving and increasingly transparent environment, they are now part of everyday life – and connected to most things people do. To grow and build trust in such an environment, banks must connect in new, more responsive and more seamless ways – not just with customers, employees and other banks, but also with regulators, business providers and society as a whole.

Being a Connected Bank today means change is the norm. This change requires banks to have viable and profitable business models that are constantly enhanced through agile innovation. But as they develop and deliver this innovation, banks must also demonstrate continually that they are aligned with – and committed to supporting – the interests of the wider economy and society.

Against this background, the Connected Banking series focuses on addressing banks’ challenges in three key dimensions:

The Future of Banking: The move to Connected Banking will bring new rules, new economics and new customers. In response, banks have to design and create new business and operating models that enable them to connect in a frictionless way.

The Digital Revolution: The need to connect intimately with the evolving customer requires banks to progress from being ‘utility’ providers of transactional banking services to becoming value-adding partners at the heart of their customers’ everyday digital lives.

Risk & Regulation: A well-connected strategic regulatory response can help banks switch from reactive survival mode to leveraging regulatory change in ways that support profitable growth.

This latest point of view in the Connected Banking series forms a part of addressing the ‘Risk & Regulation’ challenge. It focuses on how national authorities and financial regulators are dealing with the ‘Too Big to Fail’ problem through regulation. In addition, it highlights the need for each bank to get started on its journey of regulatory engagement and strategic planning so as to not be left behind the pack.

What’s next in the Connected Banking publication series?

Over the course of the coming months, we will be issuing points of view addressing different aspects of each of the three key themes identified above.

The recently released publications in the series are:

• Next Generation SME Banking
• Banking 2020
• Turning Switching to Your Advantage
• The challenge of Regulatory Implementation – a strategic approach
• Preparing for Growth – Banking Chief Financial Officers Look to the Future with Cautious Optimism
• Everyday Banking – Opportunity for Banks to reinvent themselves

The forthcoming publications are:

• FATCA – The rise of the reporting challenge
• Core Banking IT Resilience
• UKI Consumer Survey 2014

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Restructuring is no longer an option, but an imperative

As authorities and regulators, globally, grapple with exactly what it means to solve the 'Too Big to Fail' problem, systemically important banks are facing changing regulatory requirements, increased revenue and cost pressures, and an evolving & increasingly competitive banking environment. Against this background, banks will have to invest significant amounts in restructuring their organisations – something that is no longer a choice, but an imperative.

Accenture believes that this period will drastically reshape the global banking landscape – generating major opportunities for those banks that get it right.

**Restructuring and Tackling the 'Too Big to Fail' Problem**

Regulation – In a drive to solve 'Too Big to Fail', the requirements of the industry regulators are forcing banks to consider structural transformation. Two key elements of these regulatory requirements are separating a bank’s activities and ensuring resolvability. Already implemented and/or incoming regulations (e.g. Ring-fencing, Recovery & Resolution Plan (RRP 2.0), Bank Recovery and Resolution Directive (BRRD), Dodd-Frank, Capital Requirements Directive IV (CRD IV)) all aim to ensure that banks will be able to continue to offer systemically important services to local and global economies.

Revenue and cost pressures – Increased capital requirements will have a significant impact on banks' return on equity. Pressure on margins and revenues will see banks needing to strategically reduce cost and unlock new revenue pools.

Competition – Regulators in many jurisdictions are keen to boost competition in the banking market by forcing divestments by larger banks, encouraging new entrants to come into the market, and making it easier and quicker to switch banks. Banks are being forced to respond with product and service innovation to stave off heightened competitive threats.

This point of view will focus on the first driver: how the regulators and authorities are addressing 'Too Big to Fail' through regulation. We have divided this into three inter-locking but distinct components – Recovery & Resolution, Separation and Capital Adequacy. The focus here will be on Resolution and Separation in the UK, with reference to the current European plans.
Effective resolution has become central to regulators’ plans to restructure and stabilise the banking sector since events in 2008. The aim is to ensure that each bank produces, alongside the home and host state regulators, a bespoke resolution plan that articulates how systemically important banks could be resolved in an orderly fashion in the case of severe stress. The plan should be credible, feasible and robust, containing analysis of the institution’s financial, operational and legal structure.

The framework for considering Resolution in the UK has been established by the Banking Act 2009. Subsequent rules and regulations requiring firms to establish resolution plans have been outlined by the Prudential Regulation Authority (PRA), including most recently the publication of RRP 2.0 in December 2013. RRP 2.0 centres around three key principles:

- **Loss Absorbency:** Maintaining an adequate capital buffer (both quality and quantity) to ensure the failure of firms does not cause severe systemic disruption or expose taxpayers to loss

- **Operational Continuity:** Ensuring continuous provision of critical functions and critical services during resolution

- **Business Reorganisation:** Enabling banks to be split easily in the event of a failure into sub-businesses (‘resolution units’) which requires a thorough understanding of the interconnectivity between legal entities and businesses

“It is absolutely essential that the ‘too big to fail’ problem is cracked. Nothing is more important to the success of the international reform agenda. Without it...the international financial system would balkanise as individual countries sought to protect themselves. The stakes are high.”


Solving too big to fail: where do things stand on resolution, Speech given by Paul Tucker, Former Deputy Governor Financial Stability, at the Institute of International Finance 2013 Annual Membership meeting, Washington DC, 12 October 2013


Credible, thorough and bespoke resolution plans are expected from all systemically important banks.
Banks are beginning to move towards their preferred resolution strategy

UK regulators have requested each systemically important bank to provide information on their capital, legal, governance and operating model structures in order to establish a preferred resolution strategy, with a focus on enabling bail-in and ensuring operational continuity.

Recent resolution reforms have given unprecedented new powers to regulators in both the UK and EU. Banks are expected to work with regulators to identify a suitable resolution strategy and demonstrate that the structure of their business facilitates it.

Resolution as a concept is already established with banks required to be ‘resolvable’ from 1 January 2014 onwards. However under the UK’s Resolution 2.0 and the EU’s Bank Recovery & Resolution Directive (BRRD), banks are expected to create a more robust strategy using a range of resolution tools, including bail-in. These new requirements are expected to be implemented by 2016, significantly in advance of other regulatory initiatives such as ring-fencing (expected 1 January 2019). Therefore, banks must waste no time in thinking about how best to respond to the changing regulatory landscape and develop refreshed resolution strategies.

Another key change is the increased power that authorities will have in a stressed scenario, prior to a bank even entering its resolution plan. For example, authorities will have the mandate to appoint a temporary administrator as an early intervention measure.

Central to regulators’ new powers is the ability to force losses above the value of equity capital upon creditors – it is the intention that the events of 2008, where significant taxpayer funds were used to bail-out institutions through paying their creditors in full, will never be repeated.

It is envisaged that the new bail-in tool will provide the means to achieve this objective. Bail-in allows a regulator to force the write-down and/or conversion of eligible debt into equity to recapitalise a failed bank. This therefore exposes creditors, rather than taxpayers, to any future losses.

Critical to the bail-in tool’s success are two key factors: loss absorbing capacity (LAC) and an operating structure facilitating its use. Banks are already addressing LAC shortfalls under new capital adequacy regimes (Basel III) requiring increased levels of better quality capital, however banks must identify a preferred strategy for location and treatment of LAC.

Two possible operating structures have been proposed – Single Point of Entry (SPE) and Multiple Point of Entry (MPE). SPE holds LAC in a parent holding company. MPE holds LAC in multiple Intermediary Holding Companies or subsidiaries (see Figure 2 on following page). SPE is a significant innovation in capital restructuring as it promotes the ‘up-streaming’ of losses from the operating subsidiaries to the Group’s parent company, which are absorbed by the LAC, keeping those subsidiaries as going concerns. Banks must select a preferred strategy based on their current structure, geographical diversity and business model.

For example, Credit Suisse announced in November 2013 that it would change its legal structure to enable SPE, by setting up a subsidiary for its Swiss booked business (mainly wealth management, retail and corporate and institutional clients, including the product and sales hub) in Switzerland, whilst its European investment banking business will remain in its UK operations hub.

Furthermore, regulators require that a resolution plan must adequately demonstrate the operational continuity of critical economic functions and, if required, a robust plan for the future reorganisation of the business.

In order for a bank to meet these regulatory demands, significant consideration must be given to capital and funding models, governance, legal entity structure and operating model. The preferred resolution strategy will dictate any current and future restructuring – required to reach ‘resolution-readiness.’

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1 Final Secondary Legislation is due to be published by HMT in Q2 2014
2 Final levels of LAC TBC – clarification expected H2 2014
To enable bail-in, regulators will require banks to adopt an SPE or MPE funding structure

Figure 2. SPE v MPE

Single Point of Entry (SPE)
Definition: All losses absorbed by parent holding company through the write-down and/or mandatory conversion of eligible debt issued by that top company into equity via bail-in

**Suitability**: Simplicity of model suits more centralised firms with less geographic diversity. Loss Absorbing Capacity (LAC) is issued from HoldCo

**Loss Absorbency**: LAC (equity and eligible debt) issued by HoldCo. Subsidiaries upstream losses to HoldCo. Equity absorbs losses first, followed by eligible debt

**Resolution Tools**: Bail-in ensures creditors bear losses after equity has been ‘wiped out’. Losses enforced through write down of eligible debt and/or conversion into equity thus recapitalising the parent company

**Responsible Authorities**: Home authority - a single jurisdiction responsible for the consolidated supervision of the group

Home Authority Jurisdiction 1

Parent Company / Holding Company

LAC

Operating Subsidiary 1

Operating Subsidiary 2

Operating Subsidiary 3

Host authority Jurisdiction 2

Multiple Points of Entry (MPE)
Definition: Losses absorbed by individual subsidiaries through the write-down and/or mandatory conversion of eligible debt held at subsidiary level into equity via bail-in

**Suitability**: Geographically diverse group with several local subsidiaries showing high degree of legal, financial and operational separation

**Loss Absorbency**: LAC held by intermediary HoldCos. Losses are absorbed by intermediary HoldCos (or subsidiaries beneath them) rather than up-streamed to the HoldCo. Equity absorbs losses first, followed by eligible debt

**Resolution Tools**: Multi-regulated firms (e.g. regional blocs) may bail-in under multiple subsidiaries thus are likely to result in a break-up of the group into two or more separate parts using more suitable resolution tools (sale or wind-down of assets/businesses)

**Responsible Authorities**: Two or more resolution powers - i.e. home and host authorities

Home Authority Jurisdiction 2

Parent Company / Holding Company

LAC

Intermediary HoldCo 1

LAC

Intermediary HoldCo 2

LAC

Intermediary HoldCo 3

Source: Accenture
The Bank Recovery and Resolution Directive (BRRD) is intended to act as a consolidated European approach to Resolution. There is expected to be a high degree of alignment between the BRRD and the UK resolution guidelines. However, understanding the relationship between UK and EU regulators will be critical for banks as BRRD law will need to be transposed into UK law.

The latest draft of the BRRD (published in December 2013) approaches Resolution in two ways:

1. Ensuring losses from a deterioration in financial health are borne first by shareholders and then by creditors

2. Setting out new powers to maintain uninterrupted access to deposits and payment transactions, sell viable portions of the institution where appropriate, and apportion losses in a fair and predictable manner

The BRRD requires an organisation to produce both a Recovery Plan and a Resolution Plan. The Recovery Plan should present a set of measures demonstrating how management would respond to a serious deterioration of a bank’s financial situation and identify a number of triggers to implement the plan.

Should the Recovery Plan fail, national authorities are then granted “Early Intervention Powers” in an attempt to avoid failure. Examples of this include the removal of management, appointing a temporary administrator and forcing the conversion of hybrid capital instruments.

Finally, all institutions are required to develop Resolution Plans which detail how the series of tools outlined in the BRRD could be used (singularly or in conjunction) to achieve resolution.

Resolution Tools:

- **Sale of Business**: Sale of all or part of the business to a third party at commercial terms
- **Bail-in**: Recapitalisation of the failed bank through the conversion of unsecured debt instruments into equity capital
- **Bridge Institution**: Transfer to a bridge company owned wholly or partly by the resolution authorities. A bridge bank would maintain critical economic functions and is intended to be sold, wound-down or spun off by the authority at a future date
- **Asset Separation**: Transfer of assets and/or liabilities to an asset management vehicle wholly or partly owned by the regulator. An asset management vehicle would maintain critical economic functions and is intended to be sold, wound-down or spun off by the authority at a future date
- **Temporary Public Ownership**: As a last resort in systemic crises the resolution authority may take a whole or part stake in the bank

![Figure 3. Resolution timeline](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/140277.pdf)

**Key**
- UK
- EU

**Source**: Accenture

1 Supervisors of Individual firms will specify deadline for submission of Phase 1 Information within that time frame
2 Indicative date, TBC

**MREL** = “minimum requirements for own funds and eligible liabilities”

Credit Suisse to move to SPE Bank Recovery and Resolution Directive (BRRD)

How Accenture Can Help Becoming ‘resolution-ready’

Executive Summary

Connected Banking Separation of Activities

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Alongside resolution, the UK regulators are planning to force a ring-fence to separate systemically important activities. Each bank's ring fence is likely to have a different perimeter dependent on its business model and strategy, while height will be more consistent across the 'Big Five' banks¹.

Incoming UK and European legislation regarding the separation of financial services groups aims to insulate vital banking services on which households and SMEs depend. This links closely with resolvability since both aim to improve the resilience of banks and prevent inter-bank and wider market contagion in a crisis.

Height & Operating Model
In addition to the 'location' of the ring fence, banks must also consider the implications of the ring fence's 'height'. This is the degree of operational separation required, and is yet to be formally decided upon by the authorities. In the meantime, banks should assess the various operating model structures that they have as options - in terms of their current state, the transitional cost implications, and the resolvability of the proposed structure. The three main operating model structures for core support functions would be a shared service model, an operational subsidiary, or separate supporting services for each legal entity (see Figure 4).

From a transitional and 'run-the-bank' cost perspective, it is highly unlikely that any bank would independently choose to completely separate their service provision per legal entity. Separation of IT systems and data for the ring-fenced entity and non-ring-fenced entity would be enormously costly, with knock-on impacts including loss of operational synergies, no single view of the customer, and no single view of the bank. Instead, banks are more likely to pick a shared service or operational subsidiary model, and work to ensure that these do not inhibit their resolvability.

Alignment between UK and the EU
The UK is setting the pace in Europe, with primary legislation recently raised in UK Parliament. Based on the recommendations of the Independent Commission on Banking (ICB), full implementation of ring-fencing regulations is required by the 'Big Five' UK banks by 2019 (although some concessions are likely, for example pension scheme separation, which is not expected to be effective until 1 January 2026). The EU will be finalising similar legislation 18 months after the Liikanen Report, whilst other European jurisdictions (notably France and Germany) are developing their own. Quite how these regulations will play out is of particular concern to truly global banks, whose restructuring must be compliant with multiple regulatory frameworks. However, it is reassuring to know that the regulators acknowledge the additional layer of complexity caused by cross-jurisdictions. This is demonstrated by HMT delaying the publication of the Final Secondary Legislation until later in 2014 to align with European contents (e.g. perimeter and height details) and timelines.

¹ Barclays, HSBC, Lloyds Banking Group, Santander and RBS
The Market Structure Reform Directive (commonly referred to as ‘Liikanen’, after the author of the recommendations on which it is based) aims to make the EU banking system less bailout-prone by prescribing mandatory legal separation of particular risky financial activities from deposit-taking banks within the banking group. Based on these EU reforms, the various authorities within the EU (e.g. the Bank of England) can support regulators to enforce these changes.

Despite new rules on capital requirements and bank recovery and resolution, some EU banks may still remain “too-big-to-fail, too-big-to-save and too-complex-to-resolve”.

Further measures are therefore needed, notably a structural separation of the risks associated with banks’ trading activities from their deposit-taking function.

“Their proposals are the final cogs in the wheel to complete the regulatory overhaul of the European banking system. This legislation deals with the small number of very large banks which otherwise might still be too-big-to-fail, too-costly-to-save, too-complex-to-resolve. The proposed measures will further strengthen financial stability and ensure taxpayers don’t end up paying for the mistakes of banks. Today’s proposals will provide a common framework at EU level – necessary to ensure that divergent national solutions do not create fault-lines in the Banking Union or undermine the functioning of the single market.”

Michel Barnier, Commissioner for Internal Market and Services

On 29 January 2014, the European Commission proposed new rules to stop the biggest and most complex banks from engaging in the risky activity of proprietary trading. The new rules would also give supervisors the power to require those banks to separate certain potentially risky trading activities from their deposit-taking business if the pursuit of such activities compromises financial stability.

The reform will also grant supervisors with the power to ensure banks transfer other high-risk trading activities (such as market-making, complex derivatives and securitisation operations) to separate legal trading entities within the group. Banks will have the possibility of not separating activities if they can show to the satisfaction of their supervisor that the risks generated are mitigated by other means.

To prevent banks from attempting to circumvent these rules by shifting parts of their activities to the less-regulated shadow banking sector, structural separation measures must be accompanied by provisions improving the transparency of shadow banking. A better monitoring of these transactions is necessary to prevent the systemic risk inherent to their use.


Source: Accenture
The themes of Resolution and Separation are aligned and there are clear benefits of tackling both challenges in parallel

Many of the objectives and principles of the ‘Recovery and Resolution’ and ‘Separation Structural Reforms’ are aligned – making businesses more transparent, more resilient, and easier to restructure in a failure scenario. However there are also apparent inconsistencies relating to bail-in.

Where Single Point of Entry will see a move towards a simplified holding company structure, Vickers and Liikanen recommend self-financing and separately capitalised entities. This confusion may worsen if other global regulators follow suit with similar but subtly different plans for separation. The latest announcements by the EU (see previous page) have taken a step back from mandating separation; however the amount of political capital invested in ring-fencing in the UK means a similar step down is now unlikely.

Despite the shift in focus towards resolution, ring-fencing remains a mandatory process applicable to the ‘Big Five’ banks in the UK. Determining how to separate a business’s balance sheet is key to developing a resolution strategy. Conversely, regulatory guidance to date suggests that there may be concessions in relation to the required ‘height’ of the ring fence for banks with robust resolution plans. This interdependency emphasizes the need to tackle ring-fencing and resolution planning in parallel.

But, why act now?

The importance of proactive engagement with the regulators should not be understated, and in Accenture’s view it is one of the main reasons for our clients to focus on these regulations with implementation timelines still some way off. The parties involved in writing the legislation are keen to understand the specific issues that banks are concerned about, for example: which product lines will be impacted? How will the loss of operational synergies impact the bank’s bottom line?

Furthermore, building strong and collaborative relationships with regulators will be helpful far beyond just the design phase. ‘Resolution 2.0’ acknowledges that resolvability is an industry-wide challenge, which regulators and banks must tackle together. It also highlights the pertinence of each bank finding its own solution.

Banks will be required to make a number of critical choices which they can stand behind when questioned by the regulators. Reaching agreement on key points of the plan – mainly the funding & capital model, legal entity structure and operating model – with regulators from multiple jurisdictions will take time.

Looking beyond the design phase

Banks will increasingly find themselves needing to focus on restructuring activities that are not within their natural areas of core competency – and all may require external help to meet the regulations within the stipulated timelines. Figure 6 below lists just some of the key activities which will be essential in fulfilling the regulatory requirements and aligning the rest of the organisation to the target legal and capital structure.

Example Implementation Activities

- Legal entity restructuring
- Capital requirements
- Operating model definition
- Definition of Resolution Units and Critical Economic Functions (CEFs)
- Internal Contractual Service Agreements (CSAs) and Transitional Service Agreements (TSAs)
- Client contract novation
- Renegotiation of client and colleague contracts
- Colleague contract amendments
- Governance and organisation design

Figure 6. Implementation activities

Source: Accenture
Too Big To Fail? Tailored strategies, new capabilities and timely responses are now required.

The regulatory pressures faced by banks today are coinciding with the need to reduce costs, optimise the business and respond to a fast-changing competitive landscape. This combination of forces is driving banks into new territory, leaving them with no choice but to fundamentally restructure their business.

As banks consider the best way forward, two facts are clear. One is that every firm has a different starting point and a different strategy – and will therefore need to consider the impact of the regulation in the context of its circumstances and ambition. The other is that banks will need to build new capabilities. The required transformation effort will demand new skills and functionalities (at scale), that banks may not currently have within their organisations.

No time to lose

In addition to the above – time is key. The global banking industry is currently in a period where the various regulations are evolving and being finalised. This means there is a short window of opportunity to influence the regulation and support the legislative agenda for the benefit of all industry stakeholders.

Banks are now actively engaged in the journey of regulatory engagement and have the opportunity not just to reshape their organisations, but also to help the regulators understand their specific challenges.
About Accenture

Accenture is a global management consulting, technology services and outsourcing company, with approximately 281,000 people serving clients in more than 120 countries. Combining unparalleled experience, comprehensive capabilities across all industries and business functions, and extensive research on the world’s most successful companies, Accenture collaborates with clients to help them become high-performance businesses and governments. The company generated net revenues of US$28.6 billion for the fiscal year ended Aug. 31, 2013. Its home page is www.accenture.com.

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