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AN OVERVIEW OF BANKING REGULATIONS

Over the last couple of years, in response to numerous financial problems and scandals, various regulatory bodies have come up with a number of new regulations. As a result, banks are finding it extremely challenging to deal with these new as well as existing regulations.

Even though we may not realise it, a large proportion of transformational work in banking is now carried out for regulatory reasons. Consider the Basel III programme, divestment in Wealth and International Banking to ring-fence retail banking, not to mention PPI, Market Abuse, AML, and FATCA projects.

There have been push backs and legal challenges from banking associations on aspects of regulations. Thus, it's a very rapidly changing area where deadlines are being negotiated and scope is being refined.

So, this article aims to provide an overview of important regulatory bodies, key regulations, their scope and impact, especially in terms of IT. Many banks operate seamlessly in retail, commercial and investment banking space, hence key directives and regulations affecting all these lines of business are covered. The term 'regulations' is used in the broader sense to cover both directives and regulations.

DIRECTIVES VS REGULATIONS

Directives are addressed to member states rather than their citizens, and are therefore only legally binding upon the states themselves.

Under the process known as "transposition" the directive sets the framework but the practical details of implementation are left for the member states to decide.

By contrast, regulations have "general application". That means they are binding on individuals and effectively form part of domestic law as soon as they are enacted. It is generally only necessary to amend existing national provisions that are inconsistent with regulations, rather than enact new legislation altogether.

IMPORTANT REGULATORY BODIES

Key regulators operating at a global level are:

G20 - consists of the finance ministers and central bank governors of 19 countries and European Union. It aims at promoting financial regulations that reduce risk and prevent future financial crises, and at modernising financial architecture.

Basel Committee on Banking Supervision (BCBS) - provides a forum for regular cooperation on banking supervisory matters.

Financial Stability Board (FSB) - comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions and standard-setting bodies, together with committees of central bank experts. The FSB addresses vulnerabilities and implements strong regulatory, supervisory and other policies in the interest of financial stability.

The International Organization of Securities Commissions (IOSCO) – is an international association of securities regulators. It aims to establish standards and an effective surveillance of international securities transactions, promote the development and integrity of financial markets.

In Europe, following are the main regulators:

European Systemic Risk Board (ESRB) - an independent EU body responsible for overall oversight of the financial system within the EU.

European Securities and Markets Authority (ESMA) - focuses on stability of securities markets and improving investor protection.

European Banking Authority (EBA) - focuses on regulation and supervision of banks.

In the UK, **FSA** been has been replaced by Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA).

PRA oversees firm-specific regulation of key financial institutions that manage significant risks on their balance sheets. The PRA's role is to promote the safety and soundness of these firms and, specifically for insurance companies, to protect the policyholders. The PRA focuses primarily on the harm that such firms can cause to the stability of the UK financial system.

FCA has responsibility for conduct issues across the entire spectrum of financial services, the regulation of primary and secondary markets and the regulation of non PRA-regulated firms.

As you may have realised, regulators have overlapping jurisdiction and scope, which are causing the financial firms major problems in dealing with the changes.

Regulations are typically aimed at addressing specific areas of concern within the industry. The areas are as follows:

- Capital and Liquidity
- Systemic Risk
- Customer Treatment
- Accounting and Disclosure
- Financial Crime and Tax
- Payments

The following sections go into the details of each of these areas and cover the technological impact within those areas.

CAPITAL AND LIQUIDITY

Regulations in Capital and Liquidity area aim to:

- Increase the quality, consistency and transparency of the capital base, and
- Ensure that banks have enough liquid assets to meet a potential run on funds

Basel III is the main standard that falls in this category. It is divided in two main areas:

- Capital
- Asset and Liability Management

Capital

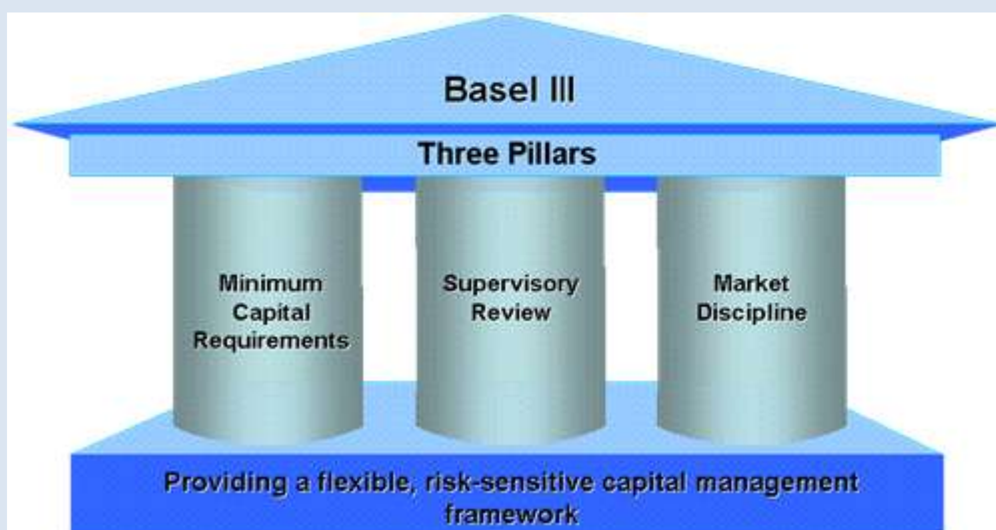
There are lot of underlying definitions and jargon – core tier 1 capital ratio, capital conservation buffer, countercyclical buffer, etc. In short, post financial crisis, there is greater obligation on banks to either raise more capital or decrease their lending.

Asset and Liability Management

Banks are required to have high-quality highly liquid assets available at short notice and exceed the net cash outflows of the next 30 days

The regulation has the following impact on banks:

- Requires banks to raise more capital
- Leads to reduced liquidity and increased costs of financial exposure
- As a result, they need to review their lending policies – whether they need different strategies, whether there are reduced funds available to lend
- May move away from certain lines of business altogether. E.g. Lloyds Bank's sale of Scottish Widows Investment (SWIP) primarily to boost its capital base. Following are the areas of business from which banks are moving away:
    - Trade finance
    - Consumer finance
    - Project finance (NSFR)
    - Public sector finance, except governments



CRD IV

CRD IV is intended to implement the Basel III agreement in the EU.

CRD IV is made up of the Capital Requirements Regulation (CRR), which is directly applicable to firms across the EU, and the Capital Requirements Directive (CRD), which must be implemented through national law.

CRD IV also makes changes to rules on corporate governance, including remuneration, and introduces standardised EU regulatory reporting - referred to as COREP and FINREP. These reporting requirements will specify the information that firms must report to supervisors in areas such as own funds, large exposures and financial information.

Technology Impacts

Following are the technological impacts:

- Greater and better use of enterprise risk management systems in order to undertake more precise risk calculations and develop new risk models.
- Greater use of Asset Liability Management systems.
- Changes in loan systems to implement control mechanisms in order to avert exposures flowing into non-performing assets.
- Better Data Access, Traceability Analysis, Aggregation and Reporting due to new data requirements, particularly as a part of BCBS.
- Using Business Process Management (BPM) solutions, banks can specialise how their processes, decision rules and data sources will work, thus aligning compliance practices with business goals and achieving full control and auditability.

Basel III	Dodd Frank
Relies on external credit ratings to determine whether assets can be counted towards the liquidity coverage ratio.	Requires that any reference to credit ratings in federal agency regulations be removed by July 2011.
Doesn’t recognise that systemic risk of assets and balance-sheets can vary over time.	Recognises that systemic risk of assets and balance-sheets can vary over time, both due to change in underlying risk of assets and collective shifts in risk-choices of financial firms.
An international, but voluntary, regulatory accord -- countries adopt the Basel standards at their own pace. CRD (Capital Requirements Directive) IV is how it is implemented in EU.	Dodd Frank is the US version. An American law (though with some extraterritorial effects on e.g. clearing of derivatives).

SYSTEMIC RISK

Regulations in systemic risk areas try to prevent the collapse of systemically important firms or groups of firms which would impair the marketplace and have significant negative impact on the economy.

All these regulations pretty much originated after the collapse of large banks and financial institutions in Europe and the US. Regulators will now look at identifying extremely important firms, require them to hold more capital, and prepare recovery and resolution plans (like we have disaster recovery plans in IT) and monitor them more closely than the rest of the financial sector. In the UK, this will be carried out by Prudential Regulation Authority.

There is greater scrutiny of transition of top management and how bonuses are handled. Some of the regulations are capital surcharges which are instigated by FSB, and crisis management proposals which, amongst other things, may require a bank to change its legal or operational structures.

Technology Impacts

IT impact is again very much in the same space as Capital and Liquidity related regulations. Two additional areas specifically covered are *IT Controls* and *Data Review and Assurance*. Essentially, both seek to make IT more reliable and resilient in a period of disruptive change.

CUSTOMER TREATMENT

These regulations aim to protect the customer and their assets, including the customer's personal data and information.

They also aim to help the customer make informed investment decisions and ensure that the products sold to the customer suit their investment profile.

As a result, banks have to provide clear communication and information to customers, and may need to change operational procedures. There are greater skill requirements especially when staff is providing financial advice to the customer.

Data Protection Act

DPA seeks to manage personal data appropriately. It lays out a set of key principles:

- Personal data should not be excessive – *are we capturing data genuinely REQUIRED for dealing with the customer?*
- Personal data should not be kept for longer than is necessary – *are we storing data we no longer need for, say, statutory or regulatory reasons?*
- Personal data should not be transferred to an external country or economic area if that external country or economic area doesn't have an adequate level of protection – *are we considering cloud, where will infrastructure be hosted?*

Financial Services Compensation Scheme

FSCS requires banks to have a single customer view (SCV) of protected customer deposits, which must be delivered to the FSCS within 72 hours of bank failure.

Of course, Single Customer View (SCV) is important from a DPA perspective as well. DPA mandates that IT controls, like security, retention, destruction of personal data, are in place.

Treating Customers Fairly (TCF)

TCF seeks to improve customer experience using various dimensions, such as corporate culture, product design, product information, customer advice, and complaints procedure.

Markets in Financial Instruments Directive (MIFID)

When a firm is trading on behalf of the client, MIFID seeks best outcome for the client on various aspects like cost, speed, likelihood of execution and likelihood of settlement.

Dodd Frank

Full expansion of Dodd–Frank regulation is Dodd–Frank Wall Street Reform and Consumer Protection Act, so there is a significant element of customer protection.

Client Asset Sourcebook (CASS)

CASS primarily impacts asset and fund management businesses. FCA requires that firms ensure that customer funds (such as investments, stocks, shares and other financial instruments) are completely segregated from any funds belonging to the firm itself, so that no mixing of funds occurs and all client money is readily identifiable as such. This is especially relevant in the event that a firm goes into liquidation, as it will protect client money from creditors of the firm and ensure that clients get their money back.

In most cases, a retail bank holds money as 'banker' rather than 'trustee' which technically takes the funds out of the scope of the FSA Client Money rules. However, similar standards of care (e.g. segregation, record keeping and reconciliations) are to be applied as a matter of best practice.

Retail Distribution Review (RDR)

RDR mandates that customers should know how much investment advice costs, they should know what they are paying for and they should benefit from improved professional standards. Previously, transaction commissions charged by advisors were not transparent to the customer.

The RDR concerns the advice and distribution of retail investment products. These include:

- Collective investment schemes (both regulated and unregulated)
- Life assurance policies with an investment component
- All investments in investment trusts, including investment savings trust schemes
- Certain types of pensions (not group personal pensions) and
- Structured investment products

Packaged Retail Investment Products (PRIPS) is also in RDR territory. It asks for clearer transparent communication through something called Key Information Document.

Technology Impacts

Main IT impacts are in the following areas:

- Single Customer View
- Integration of systems and data
- IT controls, and
- Changes in product systems, ranging from configuration changes to new product implementation

ACCOUNTING AND DISCLOSURE

The purpose of accounting-related regulations is to standardise accounting procedures across the world and provide additional disclosures. These aim to reduce complexity, improve reporting quality and ultimately boost investor confidence.

International Financial Reporting Standards (IFRS)

IFRS specifically places additional reporting burdens, such as report reformatting, granularity, and KPI measurement.

The biggest difference between IFRS and US GAAP is that IFRS uses a more principles-based approach and US GAAP is more prescriptive.

Common Reporting (COREP) is the standardised reporting framework issued by the EBA for the Capital Requirements Directive reporting. FinRep is for financial reporting.

It covers credit risk, market risk, operational risk, own fund and capital adequacy ratios.

Sarbanes Oxley (SoX)

SoX was enacted as a result of major corporate and accounting scandals, including those affecting Enron and WorldCom. It places greater accountability on top management, such as directors, to certify the accuracy of financial information and requires greater independence of auditors.

Enhanced Disclosure Task Force (EDTF) has also provided recommendations to improve disclosure by banks, including justification for internal model-based risk weightings that are substantially below both industry averages and standardised risk weightings.

Technology Impacts

IT Changes primarily affect finance-related systems. Following are key changes:

- Chart of accounts may be redesigned to accommodate multi-purpose reporting.
- Front office and supporting applications (those that post financial transactions) may need to be modified to provide key data and metrics.
- Key financial and operational reports will need to be modified and new ones developed. They should also be XBRL compliant. *eXtensible Business Reporting Language (XBRL)* is based on XML and is being adopted as finance and business reporting standard around the world. FCA also requires regulatory reporting to be done through their Gabriel system.
- The *Legal Entity Identifier (LEI)* program is designed to create a single, universal standard identifier to any organization or firm involved in a financial transaction internationally, so again master data management problem.
- Additional data requirements to support disclosures mean change through entire finance data lifecycle from creation to reporting.
- Warehouse structures may need to be redesigned to account for new data and changes in consolidation entities.
- Systems security controls have to be re-validated and may need to be modified as organization structure is updated.

FINANCIAL CRIME AND TAX

Regulations within financial crime and tax area aim at stopping illegal activities like money laundering or tax evasion.

Foreign Account Tax Compliance Act (FATCA)

FATCA aims to combat offshore tax evasion and recoup US tax revenues. However it requires global financial institutions to report on US persons if the persons hold "*income generating products*" with the firm (so excludes mortgages, loans, credit cards etc.). Note that the financial institutions may not have any operations in the US and the US persons may not be living in US anymore. So, the burden it places on financial firms is enormous.

Market Abuse

Market Abuse covers a whole gamut of things like insider dealing, and market manipulation by someone giving out false information. You may have heard of the LIBOR scandal. LIBOR stands for London Interbank Offered Rate and is deemed the most important number in the world. It is used by banks as base rate for setting interest rates for savings, loans and mortgages. It was found that there were no adequate controls in place when banks provided their borrowing rates that went to make up the LIBOR rate. Basically, LIBOR figure didn't reflect the prevailing adverse market conditions.

Anti-Money Laundering and Sanctions covers illegal transfer of funds that may be used for criminal or terrorist purposes.

Financial Transaction Tax seeks to raise additional revenues as a means of paying for some of the costs of the crisis.

Technology Impacts

In terms of IT impact, banks have to strengthen their Know Your Customer (KYC) processes, capture additional data, monitor payment transactions, and also look for outliers in customer behaviour.

PAYMENTS

Regulations in payment space aim to make payments simpler, quicker, and more secure.

Payment Services Directive (PSD)

PSD mandates faster electronic payment services, which means most customer-initiated electronic payments will reach the beneficiary's bank within a day.

Electronic payments specifically refer to payments made via BACS (such as Direct Debit) or online (such as Standing Orders, Faster Payments) and will also include payments made via Credit or Debit card.

It introduces enhanced security requirements for payment instructions, and stronger need for "customer authentication".

It provides customers with the right to an unconditional refund for a disputed payment transaction, unless the goods or services have already been used.

PSD is a legal framework developed by the European Parliament to support the Single Euro Payments Area.

Payment Services Regulation (**PSR)** is a UK law translated from PSD.

The Payments Service Directive 2 (**PSD2**) is EU legislation that is likely to become a UK Law around Q2 2017. The political drivers are innovation, competition, harmonisation and consumer protection.

PSD2 formally introduces the concept of a Third Party Service Provider (**TPP**) and defines 2 different types of service:

- **Payment Initiation Service (PIS) TPP** - To provide the customer with the ability to initiate payments from their bank account to pay for goods, in a similar manner to credit cards.
- **Account Information Service (AIS) TPP** - To provide a customer with a pan-institutional aggregated view of their different accounts.

PIS and AIS TPPs will use standard interfaces to connect to Account Servicing Payment Service Providers (**ASPSP**'s) i.e. banks. TPPs will be **regulated** under PSD2.

Single Euro Payments Area (SEPA)

SEPA initiative makes it easier to send payments to countries across the EU, using a single bank account and a single set of payment instruments.

Payment Card Industry Data Security Standards (PCI-DSS)

PCI-DSS is about protecting "Cardholder Data" and "Sensitive Authentication Data" to prevent it being compromised and used fraudulently.

Card Verification Value [CVV] (you know the last 3 numbers on the back of a card) cannot be stored and must be deleted immediately post transaction authorisation.

Cardholder Primary Account Number [PAN] (the 16 digit number on the front of a card) cannot be stored without encrypting / truncating the data.

Technology Impacts

Areas of IT impact are:

- Development and maintenance of secure systems and applications
- Testing of security systems and processes
- Encryption of cardholder data across open, public networks
- Upgrade of payment systems to support faster and simpler transaction processing, and
- Telephony updates to mask card holder data

CONCLUSION

Recent spate of regulations in banking means IT and data need to be far more reliable. Underpinning it is a requirement for increased integration and less EUC-based transformation. Enterprise-wide BPM can go a long way to ensure that your processes are well documented, traceable and compliant with regulation. The regulations are also driving an increased use of off-the-shelf products which have demonstrated strong capabilities in addressing risk and regulatory requirements. There is also a greater thrust for better IT governance, especially in the area of data, such as data quality, traceability, reconciliation and aggregation.

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