Facing New Realities in Global Banking

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RISK REPORT 2011

FACING NEW REALITIES IN GLOBAL BANKING

RANU DAYAL
GEROLD GRASSHOFF
DOUGLAS JACKSON
PHILIPPE MOREL
PETER NEU
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Four years after the onset of the global financial crisis, the banking industry continues to struggle to create value on a sustainable basis. The fallout from the crisis, together with the sovereign-debt meltdown and the slow economic recovery in major markets, has made for a difficult, volatile environment. Banks face just as much upheaval on the regulatory front. A wave of new requirements will have profound implications for banks’ balance sheets and funding strategies, and will force many banks to revisit—and in some cases reinvent—their business models.

The Boston Consulting Group’s Risk Report 2011 describes how the changing regulatory landscape will affect the banking industry and how banks need to respond. The first chapter provides a snapshot of the industry’s performance based on a global view of value creation: it covers a set of banks that together account for more than 75 percent of the banking assets in Europe and the U.S. and more than 65 percent of the banking assets in their respective markets in Asia-Pacific. The second chapter provides an overview of the new regulatory requirements—a guide that can help banks make their way through the thicket of global regulatory reform. The third chapter explores the groupwide implications of the changes, as well as the impact on individual business lines and products. The fourth chapter, which describes the state of the industry’s response, is based on a survey of major European banks.

Although some of the rules have yet to be written or finalized, the implications of regulatory reform are already clear enough for banks to take timely action. Banks that adapt quickly to the changing landscape—by taking both a regulatory and an economic perspective on reform and establishing an integrated approach to steering capital, liquidity, and balance sheets—will set the pace for their peers.

To this end, each bank must develop a detailed picture of the impact of regulatory reform, taking care to assess the changes in the context of its own unique profile—its mix of regions, businesses, and products. Only then can it decide how and where it can compete in the “new normal.”
The risk-to-income ratio (RIR) is still far higher than its precrisis level, making value creation an uphill battle for most banks: the cost of capital outweighs returns on capital, and price-to-book ratios remain low.

- The banks in our study generated a cumulative €295 billion of economic profit from 2006 through 2010.

- Risk costs—defined as the sum of capital charges and loan loss provisions (LLPs)—declined only slightly in 2010, as a decrease in LLPs was almost completely eclipsed by an 18 percent increase in capital charges, which was fueled by higher capital ratios.

- As a result, the average RIR declined only 6 percentage points to 54 percent—and was still more than double its precrisis level.

- Banks in Asia-Pacific stood out, having generated positive but decreasing economic profit since the onset of the financial crisis. Their performance was driven largely by the client-centric business models and stronger economies in emerging markets.

- Risk costs, which have been the main driver of negative value creation since the start of the crisis, are expected to remain high, in part because of regulatory change.

The most significant regulatory changes are wrapped up in Basel III, which provides a global baseline for capital, leverage, and liquidity requirements—but additional changes are on the horizon.

- The banks in our study face the equivalent of an estimated €354 billion shortfall in the capital needed to comply with the minimum Basel III core Tier 1 ratio of 7 percent. (Raising capital is not the only option for closing the gap.) To put the shortfall in perspective, banks would need to reduce their risk-weighted assets (RWA) by €5 trillion, or 17 percent, to close the gap.

- European banks account for the lion’s share of the capital shortfall—€221 billion—which is remarkable considering that they have raised €73 billion in capital since the start of the financial crisis, including €27 billion in the first half of 2011.

- The capital burden could grow even larger should government leaders fail to agree on a long-term structural solution to the European sovereign-debt crisis.

- Banks also need to contend with market-specific changes, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the U.S., which will prohibit proprietary trading, and the Vickers report in the U.K., which recommends “ring-fencing” the retail business from the trading business.

To reposition their businesses for creating value—and to regain the trust that was lost during the crisis—banks need to assess
and respond to the implications of regulatory reform for the group, as well as for individual businesses and products.

- Banks will continue to deleverage and trim their balance sheets at the group level and to rely less on cross-border and cross-currency funding for their foreign operations.

- Banks, in general, will have lower loan-to-deposit ratios. Some will cede market share to nonbank financial institutions. In light of these changes, banks will need to revisit their business models.

All lines of business will see a sharp rise in capital requirements and a decrease in profitability, but the implications of reform will vary widely.

- In retail banking, regulatory changes will intensify the race for deposits and prompt banks to move long-term assets off their balance sheets.

- In commercial banking, the changes will lead to increased disintermediation and a greater focus on debt capital markets (DCM).

- Traditional investment-banking activities—M&A, DCM, and equity capital markets (ECM)—are mainly fee driven and will be hardly affected. The global-markets business will be hit hardest—not only by Basel II+ and Basel III but also by Dodd-Frank, the European Market Infrastructure Regulation, and the Vickers report. The new requirements will trigger structural changes in the derivatives business, including greater transparency, higher volumes, and lower margins.

- Banks need to calculate the RIR at the group, business, and product level in order to create value on a sustainable basis, and the RIR will need to move to the top of the CEO’s agenda.

BCG surveyed a group of major banks in Europe—where Basel III is closest to becoming binding law—to gauge their preparedness for the changes and pinpoint areas requiring a more thorough response.

- The survey results suggest that 2013 will be the year of Basel III, with all banks aiming to comply with the new capital requirements ahead of schedule. The European Banking Authority recently introduced rules that will no doubt add a sense of urgency to the task of bolstering capital ratios.

- At the group level, most banks have already committed to the new capital requirements, and all have set target core Tier 1 capital ratios of around 9 or 10 percent—well above the 7 percent minimum.

- The new liquidity requirements are more vexing. Most banks do not expect to comply with the liquidity coverage ratio (LCR) or the net stable-funding ratio (NSFR) before these measures go into
effect. In these areas, in particular, leading banks will set a pace that could be hard for their peers to follow in the midst of a liquidity squeeze and the challenges associated with refinancing.

**Most banks have started to adapt to the new normal, but few have developed a strategy for weaving a regulatory perspective into decisions concerning capital, liquidity, and the balance sheet.**

- Banks need to reexamine the risk-return relationships at the group, business, and product levels on the basis of a clear and up-to-date view of the evolving regulatory landscape. They need to reassess not only return on capital but also return on assets, given the funding challenges facing banks.

- They also need to develop an economic view of the new requirements, so they can focus not simply on ensuring compliance but also on generating value. These steps are critical to ensuring that banks combine the regulatory and economic implications of reform into an integrated approach to steering capital, liquidity, and the balance sheet.

- The sovereign-debt crisis makes it all the more important for banks to develop such an approach. It also highlights the perils of developing regulations based solely on a historical view of risk, as well as the importance of having major financial institutions draft “living wills.”
TALLYING THE COSTS OF RISK

The global banking industry is in a fragile state. The economic recovery has been losing steam in many markets, while a wave of regulatory reform is certain to add more costs and create further barriers to creating value.

To gauge how the industry has fared over the past several years, we calculated the economic profit generated by a large sample of banks from Europe, the U.S., and Asia-Pacific. Economic profit (also called value added) provides a comprehensive measure of the financial issues facing banks. It takes a bank’s income and subtracts refinancing and operating costs as well as loan loss provisions (LLPs) and capital charges—two barometers of macroeconomic and regulatory conditions. Together, LLPs and capital charges represent the risk costs incurred by banks.

Risk costs will continue to exert pressure on banks.

Risk costs have grown substantially since the start of the financial crisis and, given the regulatory changes on the horizon, will continue to exert pressure on banks. This leads to two imperatives. To better account for these costs, banks should introduce the risk-to-income ratio (RIR) as a key metric. They should also integrate the regulatory and economic perspectives of the new requirements in order to accurately and effectively steer financial resources.

Risk Costs Are Undermining Value Creation

Banks’ low stock prices and price-to-book ratios highlight the difficulty of creating value in this sector. Our analysis bears this out.

The economic profit of the 145 banks in our study remained negative for the third consecutive year but improved to €164 billion in 2010, up from €216 billion in 2009. (See Exhibit 1.) In 2006, by comparison, the same banks had achieved a positive economic profit of €186 billion. Together, these banks held more than €51 trillion in assets in 2010 and accounted for more than 75 percent of the banking assets in Europe and the U.S. and more than 65 percent of the banking assets in their respective markets in Asia-Pacific.

Banks in every region suffered in the financial crisis, but the toll varied widely. Banks in Asia-Pacific have maintained a positive—albeit continuously declining—economic profit, owing to their business mix and high propor-
tion of deposits, as well as the resilience of emerging markets. European banks experienced the steepest decline in economic profit. From 2006 through 2010, their cumulative economic profit amounted to €355 billion. Over the same period, U.S. banks generated a cumulative economic profit of €190 billion.

The rise in risk costs was the biggest drag on value creation. (See Exhibit 2.) In 2010, banks spent €0.54 on risk costs to generate €1.00 of net income.

By comparison, they spent €0.59 on operating costs to generate €1.00 of net income. Capital charges, which increased 18 percent in 2010 due to a slight increase in the cost of capital and higher capital ratios, were more than three times what they had been in 2006. Their increase almost completely offset the sharp decline of LLPs. The net effect: the RIR of the banks in our study declined by 6 percentage points, to 54 percent, but it was still more than double what it had been just four years earlier.

The Pressures on Economic Profit Will Continue

The risk hangover from the crisis shows no signs of easing. Even if the economic recovery gets back on track, banks should expect risk costs to continue undermining value creation, largely because of the new requirements that Basel II+ and Basel III impose on their trading books. Capital costs, even if they continue to decline, will remain high, and LLPs could begin to rise again if the economic recovery stalls. In addition, some banks are increasing their LLPs as a hedge against legal concerns arising from their actions prior to the crisis.

Other determinants of economic profit remain skewed from their precrisis norms or face further challenges.

- Refinancing costs declined by nearly half from 2008 through 2010, as banks trimmed their balance sheets and central banks pursued quantitative easing and expanded the range of instruments.
eligible as collateral. But refinancing costs reversed course at the beginning of 2011 and have been rising steadily since then.

- The average cost-to-income ratio rose only slightly in 2010, to 59 percent. This was in line with its precrisis level and 12 percentage points below where it stood in 2008. But regulatory changes could cause operating costs to rise once again, putting pressure on banks to expand their cost-cutting programs and search for new sources of operational efficiency.

- Revenues declined for a third consecutive year to about €2 trillion—15 percent below the precrisis peak. Revenue growth has been hampered by macroeconomic conditions, as well as banks’ own efforts to “de-risk” their businesses.

The Need for Action

Most banks have taken a regulatory rather than an economic view of measuring and managing risk, which was a natural response to the pressures arising from the crisis. Their focus—in terms of responding to the new requirements—is squarely on ensuring compliance rather than managing risk costs and creating economic value. Banks report risk metrics, for example, but have not integrated them into key business processes or used them to influence critical business decisions.

To thrive in an era of high risk costs and greater oversight, banks need to establish an integrated approach to steering financial resources—one that combines regulatory and economic perspectives and covers risk, profit and loss, the balance sheet, and capital requirements.

- To develop such an approach, banks will need to move beyond a backward-looking measurement of risk and understand how their risk profiles might change under different circumstances. To this end, most banks will need to enhance their stress-testing, scenario-analysis, and simulation capabilities. These tools can help them develop a clear action plan for mitigating certain risks and optimizing the allocation of capital.

- Standing between banks and these aspirations for managing risk (and eco-
nomic profit) are high technical hurdles. Banks will need to upgrade their IT capabilities in order to gather, report, and analyze risk data; run and modify models and calculation engines; and generate scenarios. (The IT requirements associated with regulatory reform were described in a recent BCG report, *Moving Beyond Compliance: How Banks Should Leverage Technology to Capitalize on Regulatory Change.*)

- Banks that have developed such capabilities will be in a better position to create a culture where risk is not the domain solely of the chief risk officer but rather affects the overall steering of the organization—for example, by informing the decisions of investment committees. People throughout the bank will have a clearer perception of the bank’s risk positions, and risk in general will come to play a more important role in their decisions.

In parallel with strengthening their risk-management capabilities, banks must develop a clear understanding of the implications of regulatory reform—in global terms as well as in the context of specific businesses.
The financial crisis gave rise to a raft of reforms designed to make the global banking system more stable and less susceptible to a systemic crisis. In aggregate, regulatory reform appears to be a patchwork of disparate requirements. A broader view of the landscape, however, shows that most of the changes stem from Basel II+ and Basel III, which will lead to a fair amount of regulatory uniformity across markets—a global baseline.

Basel III, in particular, aims to level the playing field with regard to capital, leverage, and liquidity regulations. Banks will have to increase both the quantity and quality of the capital they hold while accounting for higher levels of riskweighted assets (RWA). It also introduces new leverage and liquidity requirements.

Nevertheless, differences will arise among individual institutions. For example, banks with the same portfolios could end up with different levels of RWA, owing to idiosyncrasies in their internal models. The impact of Basel III will also vary among different banking sectors. The European banking sector has an intermediated market structure. (Corporate clients generally go to banks rather than capital markets for financing.) This raises the possibility of a sea change should regulations prompt large numbers of clients to circumvent banks. In addition, European banks are relatively more sensitive to leverage and liquidity regulations. Finally, although all EU members are implementing the final Basel III requirements in Capital Requirements Directive (CRD) IV, countries may adopt different standards for countercyclical and capital conservation buffers, sanctions, and supervisory review processes, along with different principles for banking supervision and corporate governance.

- The U.S. banking sector is much more disintermediated—banks do not always stand between clients and capital markets—and has a client base that is generally more open to risk than risk-averse. U.S. banks, therefore, have smaller balance sheets and lower leverage ratios, and the industry as a whole is more sensitive to the regulation of capital markets than to the new capital or leverage requirements. The U.S. is expected to comply with the main capital, leverage, and liquidity provisions of Basel III, but the timetable for implementation is uncertain.

- In Asia-Pacific, most regulators have already announced timetables for implementing Basel III, but the transformation is expected to be less disruptive because the region’s banking sectors generally have strong ratios for both funding and
liquidity. Most Asian banks have high deposit ratios owing to high savings rates, and their client-driven business models are focused mainly on traditional banking activities.

In addition, several countries are pursuing their own regulatory reforms. In the U.S., for example, the Dodd-Frank Wall Street Reform and Consumer Protection Act is the defining feature of the new regulatory landscape. Even though many of its more than 350 rulemakings have yet to be drafted or finalized, the overall goals and cornerstones are evident.

Dodd-Frank will affect all business segments, including retail-banking margins (through the Durbin Amendment), proprietary trading activities (through the Volcker Rule), hedge fund and private-equity investments, and derivatives. Its focal point is the capital markets business, which plays a much more critical role in the U.S. than in Europe.

In the U.K., the Vickers report recommends “ring-fencing” the traditional banking business from risky activities in order to limit the type of contagion that exacerbated the financial crisis and to make it easier for regulators to wind down failed institutions. Regulators in other markets are considering similar measures for mandating resolution plans.

In order to respond effectively to this collection of reforms, banks first need to assess the implications of the changes at the group level. The new regulations pertain to capital, leverage, liquidity, and capital markets. There is also a range of measures that deal with other aspects of banking, including levies and financial-transaction taxes. (See Exhibit 3.)

Capital Requirements

The banks in our study face the equivalent of a €354 billion shortfall in the capital required to comply with the minimum Basel III core Tier 1 ratio of 7 percent. Raising capital is one way to close this gap, but banks can also narrow the shortfall by deleveraging balance sheets, spinning off risky assets, or retaining earnings.

To put the shortfall in perspective: banks would need to reduce their RWA by €5 trillion, or 17 percent, to close the gap. (See Exhibit 4.) The shortfall is largest in Europe, at €221 billion, while the U.S. and Asia-Pacific banking sectors each face a gap of about €70 billion.

- **Europe.** The implications for Europe are all the more remarkable considering the actions that many banks have already taken. The European banks in our study have raised €73 billion in capital since the start of the financial crisis, including €33 billion in 2010 and €27 billion in the first half of 2011. They have taken further steps to improve their capital ratios by reducing their RWA and retaining profits. Nevertheless, the Basel Committee on Banking Supervision considers it likely that European banks will struggle to meet the requirements.

- **The U.S.** Basel III, despite imposing a global standard for key requirements, will have different implications for U.S. banks. Compared with European banks, U.S. banks tend to keep more mortgage-servicing rights (MSR) on their balance sheets, and MSR may not be considered tier 1 capital under Basel III. In addition, U.S. banks are more active in investment banking and global markets, and this kind of activity leads to more exposure to market risk and, thus, higher increases in RWA. As a result, the regulatory changes would reduce the amount of eligible capital held by U.S. banks by 39 percent, compared with 29 percent among European banks (assuming a full implementation of Basel III). Likewise, the new rules will increase the level of RWA by 35 percent in the U.S., compared with 29 percent in Europe. Most U.S. banks, however, are already well capitalized and are therefore in a better position to weather the changes.

- **Asia-Pacific.** Basel III will have a much smaller impact in Asia-Pacific, for two reasons. First, the banking sectors in the region’s emerging markets are generally more traditional. They therefore have less exposure to complex high-risk activities. They also benefit from high deposit rates.
# Exhibit 3 | New Regulations Cover a Tremendous Amount of Ground

<table>
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<tr>
<th>Regulation</th>
<th>Description</th>
<th>Applicable region</th>
<th>Status</th>
<th>Impact</th>
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<td></td>
<td>FATCA</td>
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<td>CARD Act</td>
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</tr>
<tr>
<td></td>
<td>Investor protection</td>
<td>Stronger broker-dealer regulation</td>
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<td>![High impact]</td>
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</tbody>
</table>

〇 Under discussion  〇 Being phased in  〇 In effect  〇 High impact  〇 Medium impact  〇 Low impact

**Source:** BCG analysis.

**Note:** CRD = Capital Requirements Directive; SIFIs = Systemically Important Financial Institutions; FATCA = Foreign Account Tax Compliance Act; EMIR = European Market Infrastructure Regulation; IFRS = International Financial Reporting Standards; AIFM = Alternative Investment Fund Managers; MiFID = Markets in Financial Instruments Directive; UCITS = Undertakings for Collective Investment in Transferable Securities Directives; CARD Act = Credit Card Accountability Responsibility and Disclosure Act; VaR = Value at Risk; IRC = Incremental risk charges; OTC = over-the-counter; CCP = Central counterparty; SEF = Swap execution facility.
Second, most banks in Asia-Pacific are well capitalized. Japan’s banking sector, however, bears a closer resemblance to Western banking sectors and faces similar capital shortfalls. In fact, Japan accounts for 80 percent of the region’s capital shortfall.

For some banks, complying with the 7 percent minimum core Tier 1 ratio may not be enough. The proposed requirements for systemically important financial institutions (SIFIs) would add another 1 to 2.5 percentage points to the minimum core Tier 1 ratio for 29 banks in our study, widening the shortfall by about €300 billion. If these new requirements are imposed, these banks will face significant pressure to further reduce their balance sheets, retain earnings, and deleverage their businesses.

In Europe, large banks will need to manage their capital and portfolios with the express purpose of passing the annual European Banking Authority (EBA) stress tests. Additionally, regulators are asking for more frequent scenario calculations based on specific macroeconomic events and—through the internal capital adequacy assessment process (ICAAP) requirements in pillar II of Basel III—have required banks to integrate stress tests into steering mechanisms.

Moreover, the EU council requires European banks to comply with an EBA core Tier 1 capital ratio of at least 9 percent by June 2012 in order to provide an additional buffer against the sovereign-debt crisis. (See the sidebar “The Impact of the New EBA Capital Requirements.”) To meet this additional requirement, banks will need to close a capital short-
In October and November 2011, the European Banking Authority (EBA) detailed a range of measures designed to restore confidence in the banking sector. Under the new requirements, banks must build up a capital buffer against sovereign-debt exposure and comply with a core Tier 1 capital ratio of 9 percent. The deadline for compliance is June 30, 2012. Banks have until the end of December 2011 to provide a detailed plan for fulfilling the requirements.

The capital buffer is a hedge against potential losses on European Economic Area (EEA) government-bond holdings. It is defined as the sum of the revaluation reserve on available-for-sale government-bond holdings and mark-to-market valuations on held-to-maturity and loans-and-receivables positions, based on market prices as of September 2011. The EBA core Tier 1 ratio is built on a definition of capital that includes only commercial instruments of the highest quality, such as common equity and hybrid instruments provided by governments during the financial crisis; it excludes other hybrid capital instruments and silent participations that do not fulfill the eligibility criteria under Capital Requirements Directive (CRD) IV. The ratio also incorporates the new calculation of risk-weighted assets (RWA) that will be introduced under Basel II+.

The EBA requirements will bring forward much of the capital burden associated with Basel III, creating an urgent need for European banks to address a potential shortfall. (See the exhibit below.) In fact,
Leverage Requirements

The current market environment, which is characterized by high funding costs, low economic growth, and a widening of credit spreads, makes deleveraging a priority. Basel III’s leverage ratio makes it a requirement. The impact will be particularly acute for the European banking sector, which was highly leveraged at the onset of the financial crisis.

CRD IV in the EU defines the leverage ratio as a supplement for RWA-based capital requirements. Beginning in 2013, the ratio will be part of pillar 2 (ICAAP), but it might be moved to pillar 1 in 2018. The U.S. has already imposed a leverage ratio similar to the one proposed in Basel III, so no further changes are expected, although differences in accounting standards need to be considered when comparing the impact across regions. For example, U.S. Generally Accepted Accounting Principles, or GAAP, allow for a higher degree of netting exposure than International Financial Reporting Standards, or IFRS. Asian banks have a strong capital base and thus will not be heavily affected by the proposed leverage requirements.

Overall, we do not expect the leverage ratio to be an onerous restriction for banks. Universal banks with large loan books will automatically fulfill the leverage requirements once they comply with the capital rules.

Liquidity Requirements

Managing liquidity looms as a major challenge for banks that accumulated significant leverage and had to rely extensively on short-term funding during the crisis. The next round of refinancing will take place against a backdrop of economic uncertainty. The haircut on Greece’s sovereign debt, along with potential write-downs of the sovereign debt issued by other European countries, will reduce banks’ cash equivalents even more.

Liquidity risk is new on the regulatory agenda. Together, the new liquidity and funding requirements will further complicate banks’ refinancing efforts. The ability of banks to manage the wall of refinancing in the coming...
years will hinge on a number of factors, including government efforts to resolve the sovereign-debt crisis. Banks can ease their refinancing burdens by deleveraging and reducing their balance sheets and showcasing their solvency—for example, by demonstrating strong wholesale-funding abilities.

Basel III introduces two key liquidity requirements: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). In a 2010 quantitative impact study (QIS), the Basel Committee and the Committee of European Banking Supervisors, or CEBS, estimated that the global banking industry would need an additional €1.7 trillion in liquid assets to comply with the LCR if banks were to make no changes to their liquidity-risk profiles. The equivalent number for the European banks in our study was €1.0 trillion. Most banks will fill this gap mainly by holding additional government bonds, which, given the current discussion on assigning positive risk weights even to G-20 government bonds, will increase credit risk and capital requirements. Banks can also narrow the gap by reducing credit lines and interbank funding.

The impact of the LCR varies widely by region.

- Because Europe’s banking market is much more intermediated, European banks have relatively more illiquid assets on their balance sheets than U.S. banks have. However, covered bonds, which are common in Europe, will be counted (up to a certain limit) as highly liquid assets.

- Most large U.S. banks already meet or fall just shy of the new liquidity standards. They will have less trouble complying with the LCR, even though mortgage-backed securities (MBS), which are common in the U.S., would not be counted as highly liquid assets.

- In Asia-Pacific, the picture is mixed. Highly liquid assets must be accounted for in local currencies, and this makes fulfilling the LCR more difficult in countries such as Singapore, where public-debt levels are low. But overall, high deposit rates will ease the burden on banks in the region.

The competition for deposits and covered bonds as sources for long-term funding has already intensified. In the new pecking order, secured debt is the most sought-after funding source, followed by retail deposits and wholesale deposits. Unsecured long-term debt, even though it is attractive from a regulatory perspective, will be scarce as neither banks nor insurance companies can act as holders under the new regulatory requirements. The common practices of money market funding and swapping interest rate risk will fall out of fashion, as they entail liquidity risk.

The NSFR, by limiting maturity mismatches between assets and liabilities, will trigger even more fundamental changes in refinancing. For example, because bonds pledged as collateral will induce high long-term funding requirements under the NSFR, the repo market will become less attractive, and alternative funding sources will have to fill the gap. The net effect of the NSFR, if it comes to pass, would be profound. The Basel Committee has estimated a shortfall of €2.9 trillion globally. The impact will be particularly acute for European banks, which tend to be more reliant on wholesale funding, owing to their high loan-to-deposit ratios. According to the Basel Committee, the European banking sector would require an additional €1.8 trillion in long-term funding to meet the NSFR requirements. In Asia-Pacific, particularly Japan, banks’ stable funding is propped up by high savings rates.

**Capital Markets Regulations**

When the crisis hit, the capital requirements on the banking book were sufficiently deep to safeguard banks. The capital requirements on the trading book, however, were nowhere near strong enough to absorb the losses. In response, the Basel Committee strengthened the value-at-risk-based trading-book framework by incorporating market and counterparty risk into capital requirements.

Other capital-markets regulations are being considered by individual countries. Galvanized by the G-20’s commitment to reform derivatives markets, regulators around the world have begun changing how and where
these instruments are traded. The thrust of their reforms is to overcome information asymmetries by providing comprehensive and timely data tracking on volumes, pricing, and positions. Regulators would also like to reduce the total gross exposure of over-the-counter (OTC) derivatives, which totaled €15.9 trillion as of December 2010.

Regulators want to increase transparency and product standardization in the derivatives market.

To increase transparency, regulators want to move OTC derivatives to central counterparty (CCP) clearinghouses and encourage product standardization. The migration of standardized derivatives onto swap execution facilities and exchanges will lead to products being traded electronically rather than over the phone, and this, in turn, will lead to greater price transparency and lower margins. Central clearinghouses will be used to improve transparency, increase netting potential, and professionalize the management of collateral, which should reduce systemic risk in the industry.

Although regulators around the world are guided by these common objectives, many of them are also pursuing their own strategies for policing capital markets.

- The U.S. is pursuing the most comprehensive capital-markets reform, which includes the prohibition of proprietary trading (the Volcker Rule) and a swap push-out rule, which will drive the execution of swap business out of banks and to separate legal entities. The Volcker Rule, in particular, is expected to have a profound effect on investment banks and could also lead to restrictions on “market-making-related activities.” A tight interpretation of the rule would dampen fixed-income and equity-trading activities (particularly derivatives trading).

- Europe is in the process of ratifying the European Market Infrastructure Regulation (EMIR). It includes incentives to encourage the use of CCPs and the trading of standardized products on exchanges, along with higher collateral requirements, a central register for OTC derivatives, and additional reporting requirements. In addition, a ban on short-selling specific financial instruments, such as government bonds, is already binding.

- Regulators in emerging markets—particularly in Asia-Pacific—are defining standards and regulatory requirements for derivatives. If they decide to take a less stringent approach, trading activity could migrate to the region. A number of countries, including China, India, and Japan, have created task forces to study setting up or expanding clearinghouse operations for OTC markets. Singapore, for example, is exploring ways to attract more business by reducing transaction costs and lowering or eliminating margin-posting requirements.

Further regulations under discussion include a financial-transactions tax and position limits on commodity derivatives, which would help stabilize these markets and protect them from speculation-fueled volatility.

Bank Levies, Living Wills, and Other Regulations

Various countries, including France, Germany, the U.K., and the U.S., are introducing bank levies. Most are expected to be permanent, but the U.S. levy will expire once Troubled Asset Relief Program, or TARP, funds are fully repaid or no later than 2021.

In simple terms, the levies will be applied to the part of the assets funded by wholesale sources plus the bank’s derivatives positions. The global-markets business will be hit hardest, since it relies almost entirely on wholesale funding and involves a large derivatives book. Banks might avoid products that make a disproportionately high contribution to the tax base or derivatives with low margins. Banks with strong trading businesses might
migrate some of their activities to countries without bank levies.

Other regulations are likely to arise as a result of the outcry over public bailouts. Large banks are required to develop plans for winding down their operations should they fail. The aim is to prevent one bank’s collapse from having a domino effect that might imperil an entire system. U.S. regulators recently approved guidelines for these “living wills,” and various proposals are being discussed in other markets around the world.

Banks also need to comply with new rules on the structure of bonus schemes. In the EU, at least 50 percent of bonuses have to be paid in shares or contingent capital (equity-linked instruments), and no more than 30 percent can be up-front cash payments. In addition, 40 to 60 percent of a bonus must be deferred for three to five years and linked to the performance of the institution. The remuneration rules in the U.S. and Asia, which are currently being debated, are likely to be less restrictive. The rules, in general, could lead to a migration of talent out of European banks—either to regions that have less onerous restrictions or to hedge funds and other nonfinancial entities that are not subject to the rules.

Another topic of regulatory reform is the shadow banking system. Regulators are well aware that new requirements might lead to some activities migrating to unregulated entities. Efforts are under way to extend certain reforms to cover nonbank financial institutions.

The Need for Action

The new requirements will lead to changes in banks’ balance sheets, funding strategies, and profitability. To develop a comprehensive strategy for dealing with these new requirements, banks should focus on the following actions.

- First, they should map out the landscape of regulatory reform and its potential impact on their own business. By anticipating the requirements, banks stand a better chance of developing a coherent and timely response. They need an accurate, up-to-date perspective that captures the full range of pending and proposed rules—a single, verified reference point that takes center stage in a bank’s regulatory-reform “war room.” This will help minimize the risk of failing to comply with new requirements. Regulatory risk is fast becoming a material threat, given the number of changes on the horizon. An accurate view of the lay of the land might also help banks identify opportunities to shift some activities to less regulated markets.

- Next, banks need to begin developing an integrated view of risk—one that accounts for both the regulatory and the economic implications of business decisions. Most banks have taken steps to improve their understanding of the regulatory implications of their actions. Few, however, have married this perspective to a clear understanding of the economic implications. Banks that have such a one-dimensional view could find themselves in compliance with key regulatory ratios but still far from able to create value on a sustainable basis.

- Furthermore, an integrated view of risk would allow banks to optimize their management and use of scarce resources (namely, capital and funding)—something few banks have done. An integrated view means recognizing when and where capital is allocated within the organization and deploying it to businesses, guided by a clear understanding of the regulatory and economic implications. Such perspective comes, in part, from being able to forecast and simulate key regulatory ratios.

- Finally, because the asset values will be more closely linked to their funding structure than ever before, banks need to incorporate funding and liquidity considerations into their integrated view of risk. Banks that can attract cheap but—from a regulatory perspective—stable funding will gain a competitive edge. Thus, a strong retail platform, together with efficient covered bonds and securitization platforms, will be critical to success.
THE IMPLICATIONS OF REFORM

Given their exposure to market and counterparty risk, the investment-banking and global-markets businesses are expected to bear the brunt of the new requirements. But banks must not underestimate the possible effect of Basel III on their retail and commercial businesses as well, since the target capital ratio will be imposed institution-wide, not just on specific lines of business.

The new rules for calculating RWA will lead to a wider disparity in the capital requirements of high- and low-risk products—across as well as within product categories—and will reorder the risk-return profiles of virtually all products. Overall, the impact of reform will be remarkably uneven: the profitability of some products will be affected much more dramatically than others. Spread effects will decrease the profitability of products that already have high RWAs, such as those in the corporate business. A doubling of capital requirements on such products would be significant, given how high these requirements already are, relative to low-RWA products. As a result, the disparity in capital requirements between high- and low-risk products will go from sizable to extreme.

Retail Banking

On the whole, the retail business, which already accounts for more than half of the banking industry’s revenue pool, stands to gain from the main thrust of regulatory reform—to make banks more stable. In light of the new liquidity requirements, deposits will become an even more strategic source of funding and will continue to serve as an anchor product in the retail-banking business. However, the margins on deposits will be affected by intensified competition. Increasingly, banks with an international presence will fund their loan business through deposits drawn from different regions.

Deposits will become an even more strategic source of funding.

In some respects, however, retail banking will be negatively affected. The spread effects of higher capital requirements on bad credit standings and high-risk profiles, together with higher refinancing costs, will further compress margins on mortgages and consumer credit products, both of which will see a decline in return on equity (ROE). In addition, consumer credit products will become more of a burden in light of the new LCR and NSFR requirements. Nevertheless, credit products will continue to be the key drivers
of earnings in many regions, while mortgages will remain a core part of the retail industry in general.

Although the new regulations will increase the costs of all products, including those of the traditional plain-vanilla variety, the retail business will reclaim its role as a foundational element in banking—if it hasn’t already done so. It will be an important source of funding and profits, particularly from consumer credit products.

Corporate Banking

Business lending (corporate loans) will be hit hard by capital and liquidity requirements. The spread effects triggered by the Basel III capital requirements will drive down margins on high-risk loans and force banks to consider passing on additional costs to their customers. Even loans to high-quality borrowers could become less attractive—their margins have already thinned—because banks, particularly banks with low loan-to-deposit ratios, might incur higher refinancing costs than their own corporate clients incur. Lines of credit and liquidity facilities will become more expensive. The impact of reform varies widely across other products:

- Corporate deposits will remain an economical source of funding, but liquidity requirements will lead to higher costs, and increased competition could drive down margins.

- The capital requirements for corporate and interbank credit lines, which already entail high capital costs, will increase.

- Payment transaction products will be relatively unaffected by Basel III.

- Public finance, as a low-margin product, could be severely constrained by Basel III. Banks may consider alternatives, such as debt capital markets (DCM) advisory services. These services could become increasingly important not only for municipalities but also for corporate clients, which could come to rely more heavily on DCM.

- Trade finance, despite being a relatively riskless business, will nevertheless be affected by the new capital requirements. Its risk-return profile will need to be revisited.

Basel III will affect all commercial-banking products, but the impact will vary widely on the basis of each product’s riskiness. In order to comply with the new requirements, banks will likely have to pare back their commercial-banking activities—even though this business had no direct role in the financial crisis. The new rules—in diminishing this business—will weaken the overall economic strength of banks.

The retail business will reclaim its role as a foundational element in banking.

Investment Banking and Global Markets

The impact of reform will vary widely between the investment-banking and global-markets businesses. The traditional elements of investment banking are M&A advisory; equity capital markets (ECM), which involve the issuance and underwriting of new equity and capital; and DCM, which involves the issuance of government and corporate bonds. It sometimes includes structured lending and finance as well. The global-markets business comprises fixed-income currencies and commodities (FICC) and equity trading, and thus involves the trading of securities and derivatives in different asset classes.

Traditional Investment Banking. Basel III will have little direct impact on the growth and profitability of ECM, DCM, or M&A. These are mainly client-driven and fee-based businesses and do not involve banks’ taking large risk positions over long periods. In fact, with stricter capital requirements likely to increase disintermediation, some elements of the
business, particularly DCM, could grow as a result of reform. Given their generally long maturities and large volumes, structured lending (including loan syndication, project finance, and asset-based finance) and structured and leveraged finance will be affected not by RWA increases but by higher capital requirements. To thrive in the new environment, investment banks will likely increase their fee income (for example, through product structuring) and take pressure off the balance sheet (for example, through efficient syndication and securitization platforms).

Investment banks will likely increase their fee income and take pressure off the balance sheet.

Global Markets. The global-markets business will be the most severely affected of all banking businesses. An increase in RWA for certain products will dilute the capital ratio (equity divided by RWA) by increasing the denominator. At the same time, the minimum ratio itself will rise while a tighter definition of eligible capital will lower the numerator. The new capital requirements, in other words, will have a multiplier effect on capital costs. Three areas, in particular, will undergo significant change:

- **Market Risk RWA.** The introduction of stressed value at risk (SVaR) and, for bonds and credit default swaps (CDS), incremental risk charges (IRC) will lead to a rise in market risk RWA—and thus in capital costs. The impact will vary across different products. The increase in market risk RWA will be driven by the volatility of the respective portfolio and, in the case of the IRC charge, the migration risk of the issuer (bond) or underlying asset (CDS).

- **Counterparty Credit Risk RWA.** All OTC derivatives will be affected by charges for stressed effective expected potential exposure (EPE); a capital charge for a potential increase in the value of the derivatives, which in turn increases counterparty exposure; and a credit value adjustment (CVA) for a potential credit migration of the counterparty. The price volatility and maturity of the derivatives, as well as the migration risk of the counterparty, are major drivers of RWA increases. For financial-institution counterparties, the capital requirements are even higher, owing to the revised asset-value-correlation factor. Banks are expected to swap market risk for counterparty credit risk by increasing hedging activity, because the relative increase in market risk charges is, on average, higher than the increase in counterparty credit-risk charges.

- **Central Clearing.** OTC derivatives will be affected by the move to CCPs and the development of high-volume, low-margin platforms. Such platforms would favor competitors with strong e-trading capabilities and high volumes. The volume of standardized derivatives will increase as banks seek to mitigate higher capital requirements through the use of CCPs. Complex derivatives will trigger higher capital requirements, which banks can only partially mitigate.

These general trends have specific implications for FICC products.

- For bond trading, capital charges will increase as much as tenfold, albeit from a low level. The new liquidity requirements pose an even greater threat to bond-trading profitability.

- Credit-trading products (for example, corporate bonds and CDS) will see a larger increase in market risk than will rates trading (for example, government bonds), owing to the IRC.

- More than most other products, credit and rates derivatives are expected to move to CCP clearing, and a large proportion of them will also be exchange traded.

- The foreign-exchange business will be relatively less affected within FICC, in part
because it is already highly electronic and driven mainly by client flows.

- Owing to higher capital requirements for banks, some of the commodities business is expected to move to nonbank players, which are already strong in this market. Most offer physical trading as well.

- Increased risk weights and the imposition of a specific risk-capital charge will have a negative impact on banking- and trading-book (re)securitizations. Moreover, banks will face strict liquidity requirements for short-term liquidity lines to special-purpose vehicles (SPVs) and originators will be forced to hold a minimum share of a securitized transaction. Although only some parts of the structured-credit business can be moved to exchanges or CCPs, securitizations will play a crucial role in helping banks manage the balance sheet and are therefore likely to increase in volume.

The rules also have implications for equity trading.

- The volume of cash equity trading will be constrained by higher funding costs—which will be driven by the NSFR—but the mostly order-book-driven business will be relatively unaffected by RWA increases.

- In the equity derivatives market, plain-vanilla products that are exchange traded, along with large-cap single names, will move to CCPs. Structured products will remain OTC and trigger higher capital charges.

In the U.S., the FICC and equity-trading businesses will also be hit by the Volcker Rule, which affects proprietary trading. This is not the end of the global-markets business, however. Revenue sources within global markets will shift away from risk-taking (on the part of banks) and toward client-driven activities. Banks will need to provide derivatives to fulfill the hedging and financing needs of their corporate clients. ECM and DCM will also play more important roles for corporate clients, as the banking industry becomes more disintermediated.

To succeed in this environment, banks will need to establish trading platforms that offer broad access to investors, as well as capabilities to place new issues. There will be a shift from corporate banking to investment banking and global markets. The flip side of this coin will be higher earnings volatility, with capital markets and the trading business rising to the fore, while fees from structuring and earnings from propriety trading—which in the past could compensate for lost revenues stemming from lower trading volumes—decline.

The move to central clearing and exchange trading will transform the role of banks in the derivatives business. Efficient collateral management and margining will become sources of competitive advantage. New services will emerge as banks position themselves as providers of cash management and securities services as well as collateral financing. However, a move to CCPs, while reducing counterparty credit risk, will run up against stricter liquidity requirements. When deciding to move to CCPs, banks need to weigh tradeoffs between capital relief and higher liquidity requirements.

Securitizations will play a crucial role in helping banks manage the balance sheet.

In addition, banks could face increased competition in the trading business from nonbank players, as a banking license is not required for trading stocks, bonds, or derivatives. As a result, some of the trading business could join parts of the loan business in migrating outside the banking sector.

The Need for Action

The business of banking is at a crossroads. Over the next one to two years, banks will need to transform their business models and
make fundamental choices about how and where they compete.

- Banks need to assess the trends triggered by reform in the context of their own strengths so that they can develop tailored solutions that will allow them to defend or expand their strongholds. Retail and corporate deposits, for example, will gain strategic importance as funding instruments. Moreover, banks should reposition their global-markets business in one of two ways. They can recast it as a high-volume business that aims for large market shares. This will offset the shrinking margins on flow-derivatives execution, which will be squeezed by increased transparency and “electronification.” Alternatively, they can position this business as a niche player that is able to charge higher prices—and realize higher margins—by concentrating on less-volume-driven activities.

- The effects of reform will cascade from the top down. For each product, banks will need to recalculate the risk-return relationship in order to accurately reflect the costs imposed by reform. Banks should avoid products with extremely high capital requirements and long durations. They may need to explore alternative products that are better suited to the new environment.

- Sophisticated pricing will emerge as a critical capability. By accurately and systematically integrating risk and new regulatory costs into pricing, banks can ensure that they price risk correctly—neither underpricing, which would diminish profitability, nor overpricing, which would diminish their competitiveness. All of this, of course, is predicated on banks’ ability to generate a comprehensive and accurate view of risk.

- Timing is critical. Banks that outcompete their peers in the hunt for capital and deposits will have the means to pursue opportunities closed off to—or surrendered by—banks that are forced to shrink their balance sheets. At the same time, banks need to be conscious of the downside of being a first mover in a complex and evolving environment. This double-edged sword underlines the game theory aspect of adapting prices. If a bank moves too soon and raises prices before its peers, it could lose market share. If it waits too long to adjust prices, it could be confronted with an adverse selection and end up with high risk costs.
THE STATE OF THE INDUSTRY’S RESPONSE

THE BOSTON CONSULTING GROUP surveyed 11 major banks in Europe—which is as far along in implementing Basel III as any other region—to understand how they’ve responded to reform and the major challenges that remain. The survey, which we conducted in July and August 2011, uncovered a mix of responses, with banks being simultaneously proactive and ambivalent. The lack of decisive action on some fronts—in particular, on measuring and reacting to risk metrics at the business and product levels—opens a window for banks to gain an edge by pushing their responses further and faster than their peers.

Critical Gaps and Opportunities to Create Advantage

The survey showed that 2013 will be the Basel III year in Europe. All of the banks we surveyed are planning to comply with the new capital requirements before the year is out. (Our survey was conducted before the EBA introduced its new rules; presumably, there is now even more urgency to act.) In doing so, they will take a major step toward restoring the trust that the industry lost during the financial crisis.

About two-thirds of the banks have already introduced the new capital ratios at the business or segment level, and about half have done the same with the LCR. This does not imply, however, that the banks are using these metrics to steer their businesses or influence the pricing of individual products. Furthermore, only 18 percent of the banks have applied the leverage ratio and NSFR at the business or segment level.

Banks have divergent views on the overall impact of reform. Some expect to mitigate any effect on ROE; others expect their ROEs to decline by as much as 10 percentage points. The differences stem from a number of factors, including a bank’s business model and its prereform performance, but they also hint at the extreme variation in banks’ preparedness for both the challenges and the opportunities that lie ahead.

Liquidity Challenges. The new liquidity standards seem to pose a greater challenge than the capital requirements. (See Exhibit 5.) All the banks we surveyed have set target capital ratios that are above the regulatory minimum—in part, to telegraph their strength and stability to clients, investors, and banking authorities. By exceeding the minimum ratio, these banks have effectively raised the bar for other banks.

In addition, nearly all the banks have included the Basel III Tier I capital ratios in their risk-management and steering processes at the group level. In contrast, only 55 percent
of the banks have set higher-than-necessary targets for the LCR; 36 percent are planning to exceed the NSFR, and 27 percent will surpass the leverage ratio.

About two-thirds have included the liquidity and leverage ratios in their risk-management and steering processes at the group level but have not necessarily done so in a way that allows for an integrated approach to steering financial resources. The LCR poses a steep challenge, given that banks must replace their holdings of bank bonds with eligible government bonds, which—because of the sovereign-debt crisis—are not necessarily more stable. In addition, many banks highlighted the need to automate the calculation of LCR and NSFR, issue unsecured long-term funding, and gather more deposits.

Organizational Challenges. Most banks recognize the need to adjust their organizations and key processes to allow risk insights to influence business decisions, but it appears they still have much work to do. About three-quarters of the banks intend to hire additional risk, finance, and compliance staff, and about two-thirds are planning to centralize liquidity management and increase the autonomy of treasury management. On the other hand, only about half of the banks are planning to modify the roles and responsibilities of the treasury and risk functions, as well as the structure and role of different risk-related committees.

Of course, some banks, such as retail monolines, have less reason to revamp their risk functions, and most other banks are clearly...
planning to make additional organizational changes to adapt to the “new normal.”

Technical Implementation Challenges. The technical requirements associated with Basel II+ and Basel III are significant. The banks we surveyed cited the implementation of the CVA charge, the extended use of CCPs, and the stressed effective EPE as some of the biggest technical challenges. Other technical challenges include integrating counterparty-risk measurement and management into the bank’s risk-data and IT systems. Banks must also incorporate the risk measurement methodology on all levels (group, segment, and product), in order to fulfill the expanding range of reporting requirements.

Opportunities to Gain an Edge. The banks we surveyed have been proactive in preparing for reform. They are, to some extent, dictating the pace for the followers—some of which might feel pressure to exceed the new capital requirements to make an equally strong statement about their stability. But few banks, even among the leaders, have taken concrete steps to integrate a more accurate, comprehensive view of risk into the processes used to guide individual businesses and set the prices of products. The lack of progress presents a window of opportunity for banks to gain an edge—provided they have the capacity to quickly develop a more sophisticated, comprehensive risk-management framework.

The Need for Action

Despite efforts to fortify their capital positions and digest a set of regulatory changes, there is still some reluctance on the part of many banks. Few, if any, have taken steps to fundamentally transform who they are and what they do as a result of the changes in store—for example, by making their businesses far more client-centric and taking concrete steps to build loyalty and restore trust.

Banks need to begin developing a comprehensive plan for responding to the full breadth of reform. (See Exhibit 6.) Building up a robust capital ratio is only the start of the process, albeit a conspicuous one.

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**EXHIBIT 6 | Ten Rules for Adapting to the “New Normal”**

1. Establish integrated bankwide steering mechanisms that account for balance sheet, P&L, capital, liquidity, and leverage effects.
2. Highlight and reassess risk-return considerations at the group, segment, and product levels.
3. Develop a plan for adjusting prices that takes into account competitors’ reactions (game theory considerations).
4. Map the regulatory landscape to cut through the complexity, facilitate compliance, and identify potential arbitrage opportunities.
5. Understand that Basel III is the global blueprint and that local requirements (for example, Dodd-Frank and the Vickers report) will add challenges on top.
6. Aim to comply with—and potentially exceed—the new Basel III ratios by 2013 to keep pace with top-tier banks.
7. Plan for continued deleveraging and, in Europe, greater disintermediation as more companies shift toward capital markets.
8. Develop sustainable funding and refinancing strategies that take into account the liquidity challenges lying ahead.
9. Identify unexploited RWA reductions by upgrading the bank’s risk models and improving the quality of data management.
10. Foster the development of a bankwide risk culture on the basis of a regulatory and economic view of the new requirements.

Source: BCG analysis.

**Note:** RWA = risk-weighted assets.
• Banks need to extend their response well beyond the group level. Advantage will ultimately accrue to banks that have a clear and accurate perspective on risk throughout the organization—from both a regulatory and an economic perspective. These banks will be able to make efficient use of financial resources and pursue opportunities that would otherwise be out of reach or hard to identify. Effective risk management can do as much for a bank’s agility as it can for its stability.

• Among other steps, banks need to adjust their group-level strategy by integrating a risk management perspective into the corporate culture and adapting their strategies across all functions, including finance, treasury, corporate development, human resources, and the front office. They also need to understand the impact at the business and product levels in order to optimize the portfolio, leverage new market possibilities, and reprice products. By taking action now, banks will put themselves in the best position to emerge from this volatile period primed to both manage risk and generate value.
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:

- **Moving Beyond Compliance: How Banks Should Leverage Technology to Capitalize on Regulatory Change**
  A Focus by The Boston Consulting Group, Platinion, and SAS, October 2011

- **Operational Excellence in Retail Banking: How to Become an All-Star**
  A Focus by The Boston Consulting Group, February 2011

- **The Road to Excellence: Global Retail Banking 2010/2011**
  A report by The Boston Consulting Group, December 2010

  A White Paper by The Boston Consulting Group, March 2010
About the Authors

Ranu Dayal is a senior partner and managing director in the New York office of The Boston Consulting Group. Gerold Grasshoff is a partner and managing director in the firm’s Berlin office. Douglas Jackson is a partner and managing director in BCG’s Bangkok office. Philippe Morel is a senior partner and managing director in the firm’s Paris office. Peter Neu is a partner and managing director in BCG’s Frankfurt office.

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For Further Contact

If you would like to discuss our findings in greater detail, please contact one of the authors.

Ranu Dayal
Senior Partner and Managing Director
BCG New York
+1 212 446 2800
dayal.ranu@bcg.com

Gerold Grasshoff
Partner and Managing Director
BCG Berlin
+49 30 28 87 10
grasshoff.gerold@bcg.com

Douglas Jackson
Partner and Managing Director
BCG Bangkok
+66 2 667 3000
jackson.douglas@bcg.com

Philippe Morel
Senior Partner and Managing Director
BCG Paris
+33 1 40 17 10 10
morel.philippe@bcg.com

Peter Neu
Partner and Managing Director
BCG Frankfurt
+49 69 91 50 20
neu.peter@bcg.com