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Navigating the year ahead
Canadian regulatory outlook for financial institutions in 2017

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Table of contents

This publication is part of the Deloitte Center for Regulatory Strategy, Americas' series on the year's top regulatory trends. This annual series provides a forward look at some of the regulatory issues we anticipate will have a significant impact on the market and our clients' businesses in 2017. The issues outlined provide a starting point for an important dialogue about future regulatory challenges and opportunities to help executives stay ahead of evolving requirements and trends. For 2017, we provide our regulatory perspective on the following industries and sectors:

- Canada: Financial institutions
- US: Banking, securities, insurance, investment management, energy and resources, life sciences, and health care.

The US Regulatory Outlooks can be accessed here:
https://www2.deloitte.com/us/en/pages/regulatory/articles/center-for-regulatory-strategy-outlooks.html

We hope you find this document helpful as you plan for 2017 and the regulatory changes it may bring. Please feel free to contact us with questions and feedback at ***centerregstrategies@deloitte.com***.

It's time for financial institutions to refresh their strategies for responding to continuously evolving regulatory expectations and doing business in a regulatory, economic, and political environment that could be fundamentally more constraining.

While not all institutions will succeed in doing this effectively in the year ahead, those that do will find ways to make this new environment work for them, capitalizing on their inherent resilience, agility, and efficiency.

Foreword

2016 was another challenging year for the financial sector, with economic and political uncertainty complicating the completion of the post-crisis regulatory reform agenda.

A prolonged period of tepid economic growth and persistently low and volatile interest rates has squeezed profitability in some sectors and put significant pressure on longstanding business models and balance sheet management. Firms are further challenged by continuing uncertainty over the final shape of post-crisis financial regulation. While regulators are keen to preserve the hard won reforms of recent years, rising political uncertainty in developed economies (demonstrated by the UK's referendum decision to leave the EU and the US presidential election results) has increased the volatility and hence the unpredictability of the macro-policy environment. This has caused some to go as far as questioning the sustainability of free trade and open markets.

At the same time, the introduction of new technologies and digital distribution platforms in the financial sector are unleashing disruptive forces, promising benefits to consumers and markets, and posing further challenges to the strategies (and margins) of established firms. New technologies also stand to multiply the cyber and IT risks the industry currently faces. Nevertheless, if properly harnessed, these technologies also present opportunities for incumbents to move quickly and wisely to revitalize their business models.

2017 starts with a range of highly anticipated regulatory developments at or near their finalization. The Basel Committee on Banking Supervision (BCBS) is expected to conclude most of its banking framework, recovery and resolution planning is expected to move closer to being implemented for most large banks and increasingly clarified for non-banks, and markets are expected to continue to shift toward central clearing and higher standards for transparency. How these reforms and new regimes are implemented in national jurisdictions will, however, be more sensitive to concerns about going too far and potentially harming an already weak economic recovery. The risk of fragmentation of global regulatory approaches is rising.

From a supervisory perspective, compliance with these new requirements is the bare minimum; as important will be firms' preparedness for the unexpected. Supervisors will, more than ever, want to see that firms have robust plans in place for scenarios that could threaten their own stability, or the interests of their customers.

Strategies for a more constraining regulatory environment

Despite the uncertainty that may characterize 2017, one fact is becoming increasingly clear: financial services firms will not be able to wait out this current period of difficulty without taking decisive and, in some cases, bold actions in response. 2017 marks nearly a decade since the circumstances surrounding the financial crisis began, and many of the problems the industry has faced over this period are now starting to look more structural than cyclical. Despite a view in some quarters that the "regulatory pendulum" has swung too far, given the tastes of many politicians and policymakers worldwide (if not those of supervisors as well), the regulations that have already been implemented to date are unlikely to be materially watered down, at least not soon. If interest rates stay lower for longer in major markets, many bank and insurance business models will need to be rethought. Yet rising interest rates would not be a panacea, either, given the pressure it would put on (household) borrowers and counterparties with fragile balance sheets.

As a result, firms need to refresh their strategies for how they respond to regulation and how they do business in a regulatory, economic, and political environment that could be fundamentally more constraining. Not all firms will succeed in doing this in the year ahead. Those that do will be those that find ways of making this new environment work for them, capitalizing on their inherent resilience, agility, and efficiency.

It is in this fluid context that we present *Navigating the year ahead*, the Deloitte Center for Regulatory Strategy's Americas regulatory outlook for 2017. In it, we share our view on how regulatory themes will shape the financial industry in the year ahead and how firms can respond to the challenges they will face.

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Introduction

In light of recent global political developments, it's fair to speculate on how ongoing political shifts may, over time, reshape the regulatory landscape of the financial services industry.

Indeed, the prospect of regulatory reform for US financial institutions (FIs) over the coming months or years has only increased, as policymakers reconsider past legislation or amend the scope of certain existing regulations. This scenario has Canadian FIs watching carefully for indications of what may happen in the US, how US FIs will respond, and how Canadian markets may be affected.

Despite this air of overall uncertainty and unpredictability, there have been some indicators of the policy direction the Canadian federal government and regulators are taking. These include a number of actions intended to address systemic risks in the Canadian residential housing market, such as reconsidering both credit underwriting standards and risk distribution. As FIs look further for clues and direction to help guide their compliance strategies, actions, and investments in 2017 and beyond, they need to be proactive and pay extra attention to specific regulatory changes as they unfold, especially if the industry's trajectory shifts.

There is, however, a genuine challenge in balancing caution and action. On one hand, it's important for FIs to steer away from undue speculation. After all, most of the boldest ideas for amending or repealing existing laws and regulations in the US, for example, would need to go through the full legislative process, starting with bills in Congress. On the other hand, FIs should also make a conscious effort to avoid being paralyzed by uncertainty. With so much talk of change in the air, it can be tempting to wait for things to settle down. But, until changes are officially announced and approved, compliance with existing regulation is paramount. FIs should also be regularly testing different scenarios to uncover and understand potential risk gaps, so that no matter what happens on the regulatory front, they aren't left scrambling to solve unanticipated problems.

Many regulations that have been in the works for years are now in effect—or soon will be—and uncertainty about the industry's long-term regulatory landscape will likely be viewed as a poor excuse for non-compliance. Moreover, with many FIs having invested considerable money and effort in key regulatory-related activities, such as enhancements to risk management and compliance frameworks, it's important that those investments begin to deliver long-term business benefits, regardless of the specific regulations that are enacted.

Taking all of these factors into account, here are the regulatory trends we believe will have the biggest impact on FIs in 2017:

- Conduct, culture, and compliance
- Cyber threats and cyber risk
- FinTech and RegTech
- Fundamental review of the trading book (FRTB)
- Residential mortgages
- Risk analytics

In this report, we examine each of these trends based on what we know now, providing additional insights and high-level views on potential regulatory changes. Of course, nothing is certain until it actually happens, and 2017 will undoubtedly hold some surprises for FIs, governments, and regulators alike.


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Conduct, culture, and compliance

Conduct risk can be defined as the risk that an organization's employees or agents may—intentionally or through negligence—do something that harms customers, other employees, the integrity of the markets, and/or the organization itself.

A risk management program for culture and business conduct is designed to prevent, detect, and even predict inappropriate business behaviours and misconduct. It's also designed to create controls that mitigate the firm's exposure to conduct risk. The ultimate goal is to foster a culture of compliance and ethical behaviour that supports and protects the trust customers place in a financial services firm and that allows the firm to execute on its business strategy.

The regulatory focus on conduct has been gaining momentum in the market, in particular due to widely publicized manipulative practices in wholesale markets (such as the London Interbank Offered Rate [LIBOR] benchmark fixing scandals). However, retail sales practices are also coming under scrutiny, making misconduct issues a trend that should be at the top of FIs' agendas. Regulators are taking an increasingly wary look at practices and behaviours that appear questionable or unethical, and they are consistently citing identifiable violations.

There is a correlation between effective compliance and a strong risk management program for business conduct and culture.

In this environment, FIs are under mounting pressure to demonstrate how they are embedding a culture of good conduct within the organization, one that helps markets work well and produces fair outcomes for customers and other parties involved in a given business transaction (particularly in the area of sales and trading operations). FI's can expect increasing regulatory inquiries, actions, and fines if they can't provide evidence of a robust culture and an established business conduct risk management program.

A strong culture and conduct risk program should give senior executives greater confidence that the organization is operating with integrity and that all complaints and claims from employees and/or customers are being escalated and managed appropriately. It should also provide visibility into the behavioral characteristics that might prevent the organization from executing the business strategy in a responsible, compliant, and controlled manner.

New approaches, and demonstrable results, will be required

There is a correlation between effective compliance and a strong risk management program for business conduct and culture. Such programs are designed to detect and predict inappropriate business behaviours and misconduct and to create controls that mitigate FIs' exposure to any related risks.

Ensuring this happens, however, is easier said than done, often requiring FIs to change ingrained practices. Managing culture and conduct requires moving away from a check-the-box compliance mindset to instead adopt a programmatic approach that provides more visibility into the fairness of business practices. Notably, this must be done in a systematic way across all retail and institutional activities.

Ultimately, the challenge is to be able to demonstrate the link between business strategies, behaviours, and outcomes. FIs need to understand the risks that a given strategy might introduce, which misaligned behaviours might lead to misconduct, and how the organization's ecosystem of broader controls is currently helping to deter misconduct. Indeed, oversight of this process is already moving to the next level. The Financial Consumer Agency of Canada (FCAC) has recently completed a consultation process with industry on a proposed Supervisory Framework that includes new enforcement tools (including a Rulings Process and Notice of Breach). While still in draft form, the proposed Rulings Process promises to clarify market conduct obligations in a manner similar to the practices undertaken by the Office of Supervision of Financial Institutions (OSFI).

Without an effective, organization-wide conduct risk management framework in place—one that provides transparency into how the business is executing its strategy and conducting its day-to-day activities—FIs will find it difficult to execute effectively on a range of key business and regulatory requirements. This could include responding quickly to regulatory inquiries related to abusive, deceptive, or unfair business practices, or strategizing, acting, and managing the organization within a clearly defined conduct risk appetite. Moreover, the board and senior management won't have the critical information and visibility into key misconduct events that they need to drive the conduct, culture, and ethical agenda forward.

What should be on the conduct, culture, and compliance agenda?

An effective program for culture and conduct risk requires a programmatic and sustainable approach to identify, assess, and manage (detect, prevent, predict) misconduct and misbehaviour.

Conduct, culture, and compliance

In the end, a strong culture and conduct risk program should give senior executives greater confidence that the organization is operating with integrity.

From insight to action

As FIs strive to improve how they manage their culture and conduct programs, they should consider the following steps:

- Link conduct and culture to business strategy, articulating the types of bad outcomes (misconduct) that a business strategy might inadvertently introduce (e.g., mis-selling a credit card), as well as bad behaviours associated with those outcomes (e.g., not performing appropriate customer/product due diligence).
- Understand conduct vulnerabilities by assessing culture and conduct against conduct risk appetite.
- Perform risk culture surveys to identify potential behavioural bias, and undertake controls gap exercises to understand if conduct risk is being mitigated appropriately.
- Review and provide clarity around the conduct risk governance structure, including roles and responsibilities across the three lines of defense, and senior management accountability for oversight and management of behaviours and outcomes.
- Obtain actionable data (for example, the number of customer or employee complaints that go unresolved) to monitor risks and expose problems with prevention and mitigation.
- Understand the type of information needed to take timely action on misconduct events that threaten the integrity of the FI and its ability to serve clients.
- Use predictive analytics to model new risky behaviours and activities that could emerge in the future and to understand how existing known risks might apply to other parts of the business.
- Educate across the organization on conduct risk, particularly those responsible for implementing and supervising business activities.
- Align incentive-based compensation to foster good culture and conduct while meeting strategic goals.

In the end, a strong culture and conduct risk program should give senior executives greater confidence that the organization is operating with integrity. It should also provide visibility into the behavioural characteristics that might prevent them from executing the business strategy in a responsible, compliant, and controlled manner—an outcome that will not only benefit the business but appeal to regulators' increasingly conduct-critical eyes.

Cyber threats and cyber risk

Recent regulatory proposals underscore the fact that efforts to manage cyber risk are shifting focus from business continuity to resiliency.

Too often, organizations fall victim of trying to solve the "cyber problem"; however, cyber isn't a problem that can be fixed. Cyber is one of the highest priority business risks organizations need to manage today. More importantly, it is not one specific risk, but rather a group of risks associated with a broad range of cyber crime activities that differ in many ways, from the technologies employed, to the attack vectors used, to the methods and means of execution.

Where do we stand? And where are we going?

With the cyber threat landscape rapidly expanding, regulators are getting more involved and focusing on cyber risk as a key component of operational risk. In the US, the New York State Department of Financial Services (DFS) recently finalized a regulation that requires banks, insurance companies, and other DFS-regulated FIs to establish a cybersecurity program and comply with related requirements, including the appointment of a Chief Information Security Officer and the submission of an annual certification to the DFS regarding compliance with the regulation. The regulation also includes prescriptive requirements, such as an annual risk assessment, annual penetration testing, and quarterly vulnerability testing.

Nearly a month after the DFS originally proposed its regulation, the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued an "advance notice of proposed rulemaking" (ANPR) on enhanced cyber risk management and resilience standards for large banking organizations. The ANPR, which may be the precursor to a more formal future proposal, contemplates the establishment of a two-tiered approach comprising: (1) enhanced standards, which would apply to all cyber systems of covered entities; and (2) sector-critical standards, which would apply to systems determined to be critical to the financial system.

The enhanced standards call for financial services companies to have:

- A written, enterprise-wide cyber risk management strategy—as well as a framework of policies and procedures to implement the strategy—that is integrated into overall business strategy.
- Integration of cyber risk management into responsibilities across at least three independent functions: business units, independent risk management, and internal audit.
- Integration of an internal and external dependency management strategy into the overall strategic risk management plan.
- The capability to operate critical business functions in the face of cyber-attacks and to continuously enhance cyber resilience.

With respect to the more stringent sector-critical standards, the agencies are considering requiring entities covered under the ANPR to:

- Reduce the residual risk of sector-critical systems by implementing the most effective commercially available controls and to substantially mitigate the risk of a disruption or failure due to a cyber event.
- Establish a recovery time objective of two hours—validated by testing—for their sector-critical systems to recover from a disruptive, corruptive, or destructive cyber event.

The FRB is also considering requiring supervised entities, at the holding company level, to quantitatively measure their ability to reduce the aggregate residual cyber risk of their sector-critical systems, as well as their ability to reduce such risk to an acceptable level.

Staying ahead of a shifting cybercrime landscape

These proposals underscore the fact that efforts to manage cyber risk are shifting focus from business continuity to resiliency. As cybercrime continues to grow at alarming rates, the entire financial services industry—whose global interconnectedness both empowers and imperils its ability to function—is at risk. Financial losses are growing exponentially, and customers are demanding more access and openness around how safe their money is and what FIs are doing to keep it so.

FIs need to think beyond their security perimeter to how they can better protect their clients and approach cybersecurity more holistically. Today, clients are being attacked directly through various means (social engineering and robo-call scams, most recently). Clients being targeted directly for fraud are looking to their banks to be more proactive and provide stronger authentication services, such as two-factor authentication.

Additionally, banks need to have a stronger foothold on their supply chain, which opens the door to myriad major risks. All suppliers and extended third parties are potential vectors as they have their own security systems and gaps that can create entry points for attackers.

Within this milieu, FIs have an opportunity to work together to proactively address these critical issues. Already, members of the Financial Services Information Sharing and Analysis Center (FS-ISAC) receive timely notification and authoritative information regarding cyber events on a worldwide basis, with the specific goal of helping to protect critical systems and assets from threats.

From insight to action

Moving forward, FIs can help tackle the challenge of cyber threats and cyber risk in a number of ways. They can:

- Integrate cybersecurity resiliency into business strategy and governance across all areas of the business to ensure that FIs have the right processes in place to respond and recover from an attack.
- Understand the supply chain to identify risks and possible entry points into FI networks to ensure client data is protected.
- Perform routine threat simulations to test cyber response processes and make modifications where required.
- Work with government regulators to understand the impact that new regulations will have on current business models.
- Become FS-ISAC members and work with other FIs not only to share intelligence but also to identify and understand the largest and most critical threats likely to affect the industry.

The interdependent nature of financial services and technology, combined with the ongoing development and dissemination of cyber-crime techniques by cyber criminals, demonstrates the importance and fiduciary responsibility of building an equally interdependent response.

FinTech and RegTech

FinTech

The term *financial technology* (FinTech) applies to the many technologies that are transforming the financial industry, as well as to the companies that use them.

This rapidly growing market represents both a competitive threat and an opportunity for traditional banks. The technologies themselves, which vary widely but share the properties of being designed to remove friction from existing processes and interactions, include distributed ledger technology (blockchain) and the bitcoin cryptocurrency it enables; robotics, for example financial robo-advisors and other machine learning technologies; platforms for mobile banking and trading; and more.

FinTechs are also creating disruption—they are ready to compete directly with banks for loans, payment products, investment management, and other services.

Although they still represent a relatively small share of the overall financial industry sector, FinTech firms are growing rapidly. Compared to traditional banks, FinTech firms have generally demonstrated the ability to innovate in more creative ways. For example, FinTech firms have developed loan origination platforms that pull information directly from customer tax records and other financial service providers, making the process faster, more productive, and effective—and at a lower cost for both the customer and the institution. FinTechs are generally platform-based, capital light, and use data as a strategic asset. Traditional banks—many of which are hampered by legacy systems, siloed processes, and static cultures—find such rapid innovation harder to achieve.

Despite FinTechs' innovation advantage and focus on market expectations, they are facing increased scrutiny from regulators and skepticism from various risk domains as their popularity grows.

Getting with the program

Traditional banks have some specific advantages over FinTechs, including strong balance sheet capacity, funding sources, established global payment networks, stable capital bases, customer relationships, and regulatory alignment. On the other hand, FinTechs are also creating disruption—they are ready to compete directly with banks for loans, payment products, investment management, and other services. To bring enhanced capabilities to market more quickly, lower their cost-of-entry into new technologies, and grow market share, many banks are looking to adopt FinTech strategies, including setting up innovation labs and accelerator arms, as well as partnering and/or acquiring FinTech firms.

There are many ways that banks can partner with FinTechs to leverage their expertise and innovative technologies. For example, a FinTech company could underwrite loans using their cheaper, simpler loan origination platform then sell them to the bank in a volume-controlled, effectively monitored portfolio. On the payment side, banks could look to source a mobile interface that provides a better customer experience and offers next-generation security (e.g., biometrics/location based identification). FinTech solutions for mining 'big data' could also be used by banks to better capture credit portfolios and deposit behaviors, leading to improved risk management.

There are challenges associated with the bank/FinTech partnership model, including how the two parties typically operate with different risk appetites. Partnership combinations with banks would also expose FinTechs to the their prudential regulatory requirements and governance expectations. While these are challenges associated with the partnership model, if made to work they could potentially offer stronger customer outcomes and enhanced market competition.

To establish effective partnership models with FinTechs, FIs should also have robust supplier risk policies, controls, standards, and processes in place for the partnership model, including assessing the effectiveness of the partner's control environment.

Expanding the financial paradigm
We believe that by combining their unique strengths, banks and FinTechs have the potential to create more value together than individual innovation initiatives. It is worth noting that many regulators are engaged and encouraging innovation and FinTechs, as seen with regulatory sandboxes, the FCA in the UK and OSC in Canada. Given that the OCC in the US is exploring the possibility of making a limited, special-purpose national bank charter available to FinTech firms, banks everywhere, including in Canada, should consider actively exploring how they can put FinTech capabilities to work in their own organizations.

The influence of FinTech can be a net positive for FIs, particularly those who are able to act now, act decisively, and make the right strategic choices. FIs can thrive in a disrupted world, but they need to be proactive in managing change. They also need to understand how FinTechs will impact them before taking advantage of any potential benefits—which are more likely to accrue to pioneering FIs, given that everything is still in its infancy.

FinTech and RegTech continued

From insight to action

Based on our experience working with bank and non-bank financial institutions, we have identified a number of components that should be part of a sound risk management framework. Each component requires effective design, methods for continuous improvement, and ongoing assessment across people, processes, and technology. FIs should seek to:

- Stay abreast of regulatory developments related to FinTech firms and partnership arrangements, exploring ways to enhance their bank services by partnering with, or possibly by investing in or purchasing, FinTech firms.
- Regulatory interaction and coordination, in which an enterprise-wide view of regulatory activities, planned examinations, and interactions with regulators is developed.
- Understand what capabilities they should be looking to outsource or acquire through partnership. Suggested principles for guiding this decision include: activities that are highly manual/repetitive; activities that do not provide competitive advantage and are table stakes in the industry; activities that rely on legacy technology that is hard to modernize.
- Understand the FinTech sector and its evolution as broadly as possible through collaboration with FinTech leaders, such as by:
  - Attending industry events, forums, and roundtables that bring both sides together
  - Visiting established clusters and ecosystems, such as Silicon Valley, Washington DC, Waterloo, Ontario and Israel's The Floor.
  - Learning about accelerator program options, startup capabilities, and other venture capital opportunities.

RegTech

While FinTech is transforming industry capabilities and business paradigms, its rapidly growing corollary, RegTech, is changing the ways businesses respond to the growing post-financial crisis regulatory and compliance requirements. Although those requirements have closed gaps in the regulatory framework, meeting them—combined with a subdued global economy and necessary investment in financial consumer technology—has placed a heavy cost burden on many FIs to the tune of a 60 percent increase for retail and corporate banks over pre-crisis levels.[1] RegTech—defined by the Institute of International Finance (IIF) as "the use of new technologies to solve regulatory and compliance requirements more effectively and efficiently"—holds great potential to drive compliance costs out of the business while increasing efficiency, driving profitability, and reducing barriers to sector entry.

Opportunities and challenges

While technology has been a staple of the regulatory process for some time, clear and significant advantages can be realized by adopting emerging RegTech capabilities, many of which leverage existing systems and data. This can allow FIs to produce data and report in a cost-effective, flexible, and timely manner without replacing/updating legacy systems. They may also be able to improve data agility with Extract, Transform, Load (ETL) technologies; mine enterprise datasets using analytics for a broader range of reporting purposes; and configure and generate reports more quickly.

Overall, RegTech solutions most effectively improve five key areas: risk data aggregation; modelling, scenario analysis, and forecasting; real-time payment monitoring (used to meet anti-money laundering/anti-terrorist financing regulations); identity verification; and monitoring the introduction of new regulations.

Despite this potential, there can be significant implementation barriers. For example, some current data protection/localization rules create silos of data that can limit the information sharing much RegTech requires, while regulatory deadlines around IT updates can lead to patchwork systems rather than a full RegTech overhaul. And with outcome-based rather than process-based regulatory reform still underway, deciding how to respond to regulation is at best ambiguous. Each FI has to determine for itself how to comply, which can create unique stacks of compliance processes. Accordingly, many FIs are hesitant to settle on a particular RegTech solution.

Meanwhile, these barriers all hold for FinTech solutions, as well.

An increasingly important tool for risk

As it stands, RegTech is a niche market that requires collaboration between many industry participants, including regulatory experts, technology and software developers, and investors/entrepreneurs. However, the benefits—particularly for FIs' risk and compliance functions—outweigh the challenges.

From insight to action

Risk and compliance functions should self-assess their ability to provide effective oversight as their organizations become more digital and consider how RegTech might help. To that end, they can:

- Assess the compliance control environment, considering what processes are built or layered over time.
- Assess existing organizational regulatory technology, identifying areas that can be augmented with new innovations.
- Understand what capabilities can be outsourced effectively.
- Develop a RegTech strategy that aligns with upcoming regulatory data and reporting requirements as well as any impending regulatory changes.
- Understand the restrictions that apply to FIs (e.g., inability to share data), develop options and/or workarounds.
- Encourage an overall culture of technological innovation and change, developing good sensing capabilities to identify how FIs can leverage new RegTechs. Those with strong connections to regulators will be able to influence and shape the development of new regulation.
- Consider peer practices, specifically how others are making RegTech work for them.

"In the short term, RegTech will help FIs automate mundane compliance tasks and reduce operational risks associated with meeting compliance and reporting obligations. In the longer term, it will empower compliance functions to make informed risk choices based on data-provided risk insights."

Sean Smith,
Risk Advisory Partner, Deloitte Ireland

1 Deloitte (2017, February) The future of regulatory productivity, powered by RegTech. https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-regulatory-future-of-regulatory-productivity-powered-by-regtech.pdf

Fundamental review of the trading book

FRTB was prompted by significant shortfalls in required trading book capital during the financial downturn.

In January of 2016, the Basel Committee on Banking Supervision published its Standards for Minimum Capital Requirements for Market Risk—also known as the "Fundamental review of the trading book" (FRTB)—to address market risk deficiencies that emerged during the 2007-08 global economic downturn. The new rules, which must be implemented by national authorities, will take effect in 2019. Forming the basis of a more robust trading book framework, the changes are built around the principles of increasing sensitivity and enforcing both the uniformity and comparability of approaches across FIs.

FRTB was prompted by significant shortfalls in required trading book capital during the financial downturn. The fundamental review seeks to fill gaps, improve calibration, and ultimately ensure that trading book capital requirement approaches are better aligned with the trading books underlying risk. The effort also seeks to reduce the variability in modeling outcomes and creates greater hurdles in terms of qualitative tests of reliability, as well as capital penalties if models are not performing well.

What does this mean for FIs?

First, FIs will need to respond to the capital changes caused by the FRTB. The impacts on capital must be fully understood and used to shape future business strategy. Second, the FRTB introduces major front-to-back office framework changes, such as enhanced disclosure and increased requirements for risk finance alignment. To meet this challenge, a robust set of FRTB compliance processes and controls are key. There will also be major impacts on IT and data in relation to FRTB implementation, with systems across risk, finance, and the front office requiring substantial development work. Early documentation for requirements is essential to ensure nothing is missed.

The infrastructural changes required to implement the FRTB standards will be significant, if not transformational. While detailed FRTB implementation requirements have yet to be defined, FIs should begin considering the implications now, as required changes may result in additional costs and other ongoing compliance challenges.

In addition to these overall impacts, FIs can anticipate a number of specific issues to arise under FRTB:

- Exposure to greater supervisory scrutiny:
  - FIs will need to consult more actively with supervisors than they do today, particularly for the management of model risk and to ensure trading desk rules are properly observed.
  - Supervisors will review and, in some cases, have the right to reject risk management strategies and specific transactions.
  - Supervisors can more easily revert specific desks back onto the standardized approach while issues get resolved.
- Reduced flexibility will likely lead to higher costs:
  - Restrictions on transfers between the regulatory books will likely increase capital requirements.
  - The new internal risk transfer (IRT) rules effectively reduce capital benefits resulting from being a universal bank.
  - The need to match external hedges to IRTs can be costly and has raised questions as to whether this can provide the market with greater visibility into banking book hedging strategies.
- Heightened public disclosure requirements:
  - Re-designations between the different regulatory books, if permitted at all, will be subject to public disclosures.
- Enhancements to existing systems and controls will be needed:
  - FIs will be expected to implement and maintain a robust systems and control framework to ensure segregation between the regulatory books at all times.
  - Adequate systems are required to identify and map external hedges with their corresponding IRTs.
- Enhanced documentation and risk management requirements:
  - FIs using the standardized approach will be subject to more onerous documentation and risk management standards with respect to maintenance of the boundary.

Adapting to FRTB will be challenging but value-enhancing

FRTB is in many ways far more complex than the existing framework. With that in mind, it's important for FIs and regulators to engage with each other early to avoid duplicating efforts and to mitigate unintended consequences that can arise with any major change.

It's important to remember, though, that certain key benefits may lessen the challenges of implementation. FIs that seize the opportunity to optimize their front office from a capital and organizational perspective, rather than just "shoehorn" in existing legacy structures to meet requirements, will be at a distinct advantage in the post-FRTB world. For example, given the significant effort required to implement the revised standardized approach (since it has undergone significant methodological changes), FIs should leverage that effort further to improve internal models and risk measures. And by applying an appropriate methodology for allocating capital across specific desks and business areas, FIs may gain a better understanding of capital allocation drivers, which may prove valuable as they shape their strategic responses to the FRTB.

Fundamental review of the trading book continued

FIs that seize the opportunity to optimize their front office from a capital and organizational perspective, rather than just "shoehorn" in existing legacy structures to meet requirements, will be at a distinct advantage in the post-FRTB world.

From insight to action

There are a number of actions FIs can take now to ensure they are ready to meet the requirements of the new FRTB regulation. They can:

- Assess/improve existing model risk management by building capabilities across all three lines of defense.
- Enhance the governance and operating model by defining roles and responsibilities across all functions and businesses, including decision rights and activity/process handoffs.
- Optimize front office and foster innovation from a capital and organizational perspective to be able to take advantage of regulatory changes.
- Improve risk assessment and regulatory change by mapping activities and controls to define laws, regulations, and industry standards.
- Test controls for design effectiveness and appropriateness, and determine residual risk that will drive the frequency of monitoring and testing.
- Define scope and frequency for monitoring and testing based on risk assessment results and remediation plans.
- Establish a change management process to accommodate new or amended regulations and product offerings.
- Develop strategies, policies, procedures, and controls that reflect the organization's risk appetite, and align risk management and business strategies with consistent goals and measureable objectives.

Moving forward, FIs looking to effectively facilitate the FRTB process should consider a range of key activities, including ensuring budget is aligned with the steep demands that will be felt across the entire model inventory (which will involve much more than just stress-testing models) and promoting an organizational culture that values effective challenge and debate around major change initiatives.

Residential mortgages

In recent years, a number of issues have emerged in the Canadian residential housing market that have raised concerns with regulators and the federal government. These include:

- The overheating of the market, especially in Vancouver and Toronto, leading to unaffordable housing.
- Highly indebted Canadian families.
- The potential impact of interest rate hikes.
- A low-growth economic environment.

A shift in any of these factors or a departure from current relatively favourable conditions could threaten the stability of the Canadian economy. This fear has forced regulators and the federal government to revisit the current suite of regulations and requirements for mortgage lending practices, and significant changes are on the way. While the full impact of any new regulations may not become clear for some time, mortgage lenders should act now to understand what changes are imminent, consider their own response, and look at innovative strategies for staying competitive in this shifting environment.

What changes are coming?

Continuing with the tradition of strong government oversight, significant changes are now being made to Canada's mortgage and foreign ownership rules for real estate. The aim is to encourage mortgage lenders to more fully mitigate the risks they assume in their lending and insuring activities. Four key measures were annouced late 2016:

- Stress tests will be expanded to include all insured mortgages, not just those with a down payment under 20 percent. Home buyers will now be required to demonstrate that they are able to service their debt under different scenarios, potentially making it harder for buyers to get an insured mortgage solely on the basis of a large down payment.
- A loophole allowing some foreign buyers to claim capital gains tax exemptions on sold properties falsely claimed as a primary residence will be closed. They must now file taxes in Canada, as a resident, the same year they buy a home, before later claiming the principal residence exemption on any gains for that year.
- The federal government is holding consultations to see if mortgage lenders can feasibly take on added lending risks. While this would result in a shared payment burden for insured mortgages should a housing crash occur, it would also require mortgage lenders to increase liquidity, and the most likely means would be through an increase in mortgage rates.
- Restrictions on portfolio insurance—a type of bulk insurance for mortgages with down payments of 20 percent or more—will be changed.

A number of specific impacts will be felt

The intent of these changes is to enhance stability, regain some control over the trajectory of housing values, and ensure that any potential systemic adjustment to those values is as orderly as possible. While enacting substantial changes in the face of an evolving economic and regulatory climate can have consequences that are difficult to predict and control, some effects are almost certain to be felt in the areas of underwriting and lender risk-sharing.

Underwriting

- Mortgage lenders will be required to exercise greater due diligence when verifying borrowers' income levels, especially where foreign capital is involved, and when considering loans to borrowers with high household debt levels or low credit scores.
- Lenders must enhance measures that will help to ensure customers will be able to make mortgage payments if interest rates rise.
- The enhanced due diligence required to support changes to underwriting and adjudication practices may require additional time and effort, as well as new processes and systems, and is likely to result in increased costs.
- Lenders and mortgage insurers will need to ensure appraised values of housing reflect fair market value when approving loans, particularly in cases where home equity is being deployed in support of a credit application.

Lender risk-sharing

- Lenders will be required to have greater capital reserves to absorb more severe losses. New regulations will also require enhanced risk management practices to combat fraudulent mortgage practices.
- Funding strategies will have to be readdressed to more fully account for these new risks.
- The need for mortgage lenders to have greater levels of capital reserves could ultimately put upward pressure on mortgage rates.
- Mortgage lenders will have to consider innovative ways to increase profitability around mortgage products, including:
  - Decreasing costs around mortgage processing and underwriting
  - Refocusing on new segments
  - Using advanced analytics to improve auto adjudication approval rates
- Stricter customer due diligence requirements will increase compliance demands on underwriting processes.
- Mortgage lenders will need to re-evaluate their business strategies, processes, and operating procedures around products and services—by, for example, modeling different future business and economic scenarios.

A partnership model takes banks and lenders to the next level

Given changes in the current regulatory landscape and evolving customer expectations, banks and lenders should look to develop mortgage business models and platforms that deliver materially lower costs for origination and ongoing service.

From insight to action

To benefit from imminent and anticipated regulatory changes, FIs can:

- Assess how regulatory change will affect the cost structure for the current mortgage model and consider how this will affect profitability.
- Strategically re-think enhancing or transforming capabilities, such as by emphasizing a partnership ecosystem for banks and lenders; this would help automate and streamline mutual processes while improving both quality control and regulatory compliance outcomes.

Such innovative mortgage business models can set banks and lenders on a stronger path to cost savings while staying compliant in an evolving regulatory landscape.

Risk analytics

By using a range of techniques and technologies to measure and quantify risks represented in financial and economic data, as well as to calculate likely scenarios and forecast future events, banks can create a consistent methodology that is well-supported by data-driven insights.

Daily headlines keep reminding us that new risks—and requirements to continually refine and even replace mitigation strategies—now arise with increasing frequency. The field of analytics sits at the forefront of that challenge, making it possible to better measure, quantify, and even forecast risk with more certainty than ever before. Herein lies the potential for the financial services industry to make smarter and faster decisions to meet today's evolving demands.

Advanced analytics capabilities not only enable clearer visibility into operations, regulatory compliance, supply chain, finance, e-commerce, and credit risk challenges, they also help banks enhance their "risk intelligence" by clearly defining, understanding, and managing their tolerance for—and exposure to—risk.

The upside of risk analytics

Historically, many FIs have responded to new regulations with ad hoc solutions, leading to systems replete with gaps, overlaps, redundancies, and manual requirements, all of which increase inefficiencies, costs, and risks. Given today's volume of regulatory demands, such reactive efforts are fast becoming unsustainable.

In the current regulatory environment, basic reporting and descriptive analytics are a must-have for banks; however, the real differentiator comes from advanced predictive analytics that generate powerful insights, break down silos that inhibit information flow, and have true, value-added business impacts. This enables organizations to more effectively aggregate data, regulate the integrity of that data, and identify and leverage the information that matters most to their businesses.

Analytics can significantly enhance FI's ability to implement business strategies, achieve goals, address risks, and manage the challenges of competitive advantage, profitability, and growth

When it comes to regulation, analytics has two sides to bear in mind. On one hand, analytics capabilities can help organizations manage both the cost of compliance and the risk of non-compliance by accessing key regulatory data faster, more accurately, and with greater specificity than before. On the other hand, analytics is itself increasingly being impacted by regulation as it becomes more prevalent in the banking industry.

Many aspects of the current regulatory landscape directly affect data, analytics, and technology:

- Legislation such as Dodd-Frank; the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act; the Foreign Account Tax Compliance Act (FACTA); and Basel III have changed the business environment for banks and include requirements impacting a range of technologies.
- Given the focus on systemic risk, regulators are pushing banks to demonstrate better understanding of the data they possess, turn data into information that supports business decisions, and leverage data to manage risk more effectively.
- Regulators are beginning to make more effective use of bank data submissions as the field of analytics grows in capabilities and importance. As a result, the very advantages that accrue to FIs through enhancements to analytics frameworks also serve to enhance the depth and breadth of scrutiny by regulators.
- Ongoing regulatory change will result in transformations within banking; those able to develop business models that align with a radically different regulatory environment will be more competitive.

Analytics can significantly enhance FI's ability to implement business strategies, achieve goals, address risks, and manage the challenges of competitive advantage, profitability, and growth—all while continuing to comply with core, new, and evolving regulations.

From insight to action

Risk analytics will be a significant competitive differentiator for firms that understand how to use these tools effectively to make decisions—decisions that drive business growth, improve risk management, and ultimately reduce costs. To help achieve these ends, FIs can:

- Improve data, measurement, and reporting by identifying key risk performance indicators (KRIs/KPIs) and monitoring progress with regular and consistent capture, measurement, and reporting.
- Take a systematic approach to utilizing available data to run analytics in order to address identified pain points and/or priorities.

The field of risk analytics has the potential to transform the competitive environment. FIs need to ensure they have the capabilities to participate fully in this transformation process and, where possible, to play a key role in shaping their own environment, rather than merely reacting to change as it happens.

Going forward, FIs need to see where the opportunities lie, then create innovative strategies to seize them. Risk analytics can help by enabling banks to make better decisions, become more profitable and competitive, and gain new customers, new revenue, and even new markets along the way—all while keeping step with whatever regulatory challenges may come.

The way forward

2017 holds the promise of becoming a year of higher than normal regulatory uncertainty. The shifting political contours both in the US and Europe mean that participants in the financial services industry will need to pay even closer attention to rule makers, standards setters, and legislators to understand both evolving political sentiment and the complex regulatory landscape. However, while performing this necessary diligence on emerging trends will be important, nothing should take attention away from the core focus of identifying and understanding significant regulatory risks and maintaining strong control environments.

At the Deloitte Center for Regulatory Strategy, Americas, we will be continuously monitoring and analyzing new regulatory developments as they unfold throughout the year.

For the latest news, trends and insights, please visit our website at **www.deloitte.com/us/about-dcrsamericas**. Global trends are available at **https://www2.deloitte.com/us/en/pages/regulatory/articles/center-for-regulatory-strategy-outlooks.html**.

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