Banking | the way we see it

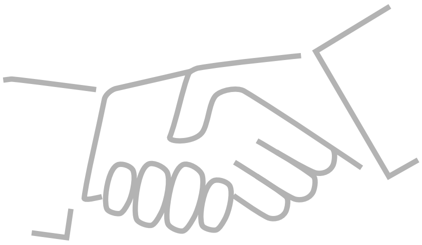
Impact of Regulations on Bank Lending

Regulations have to strike a balance between providing a safe environment for banking while ensuring adequate credit growth

People matter, results count.

Table of Contents

1 Introduction



Following the financial crisis of 2007–2009, there has been a significant number of follow-up reforms implemented that are aimed at strengthening and safeguarding the banking sector. The supervisory pressure is particularly high in the United States and Europe, which have seen a spate of regulations in the areas of capital, governance, market infrastructure, financial crime and taxes, accounting, and disclosure and remuneration.

While the Basel Committee enhanced the capital and liquidity requirements (Basel III), the U.S. Federal Reserve came out with its own Dodd-Frank Wall Street Reform and Consumer Protection Act and Volcker Rule, prohibiting banks from engaging in short-term proprietary trading. Similarly, Europe has been subjected to a series of regulatory packages, such as the most recent Capital Requirements Directive, CRD IV, Markets in Financial Instruments Directive, MiFID 2, and the European Market Infrastructure Regulation, EMIR.

Banks are now feeling the aggregate impact of the recent regulatory requirements that were introduced in the aftermath of the financial crisis. The global regulatory reform agenda has imposed a significant cost on banks and this rash of regulatory reforms is perceived by banks as hindering their ability to support credit growth and economic recovery.

Exhibit 1: Global Regulatory Footprint

North America

2010 – Enhanced Prudential Requirements for Banks: Dodd Frank Act mandates requirements for stricter liquidity, leverage and risk management systems

2012 – Volcker Rule: The rule prohibits banks from engaging in short-term proprietary trading of certain securities and derivatives from their own account

2013 – Liquidity Rules for Large Banks: The proposed liquidity coverage ratio by FDIC would require banks to hold minimum amounts of high-quality liquid assets that could be quickly converted to cash to cover any net cash outflows during crisis

2014 – Stress Testing and Capital Planning: U.S. Federal Reserve has issued guidelines for internal stress testing for banks of different sizes and rules for capital planning under Comprehensive Capital Analysis and Review (CCAR)

Europe

2010 – Basel III: Basel III will be implemented in the EU from January 1, 2014, through the CRD IV package – the Capital Requirements Regulation (CRR) and the Capital Requirements Directive

2013 – Capital Surcharges for Global Systemically Important Banks (G-SIBs): The Basel Committee has announced prospective capital surcharges for 29 G-SIBs

2014 – Mortgage Market Review (UK): The MMR sets out the case for reforming the mortgage market to ensure it is sustainable and works better for consumers

Asia-Pacific

Capital Requirements – Asia-Pacific countries, such as India, Indonesia, Malaysia, are implementing higher capital ratios on the lines of Basel III

Reserve Bank of New Zealand has implemented a restriction on the level of high Loan-to-Valuation residential mortgage lending

Source: Capgemini Financial Services Analysis, 2014; “Regulatory Changes in the Investment Banking Industry”, Capgemini, 2014

2 Impact of Regulations on Lending

The combination of increased capital requirements, capital buffers, and minimum liquidity requirements are likely to negatively impact the return on equity for banks. While the heightened regulatory requirements will affect banks' availability of capital, the cost of maintaining higher capital and liquidity requirements will also have an impact on credit pricing. The recapitalization effort will affect banks' supply of funds forcing banks to look for ways to reduce lending, as they struggle to maintain a regulatory minimum. This would force banks to look for ways to improve operational efficiency, dispose of non-core assets, reduce retail deposit rates and seek ways to improve margins on existing products.

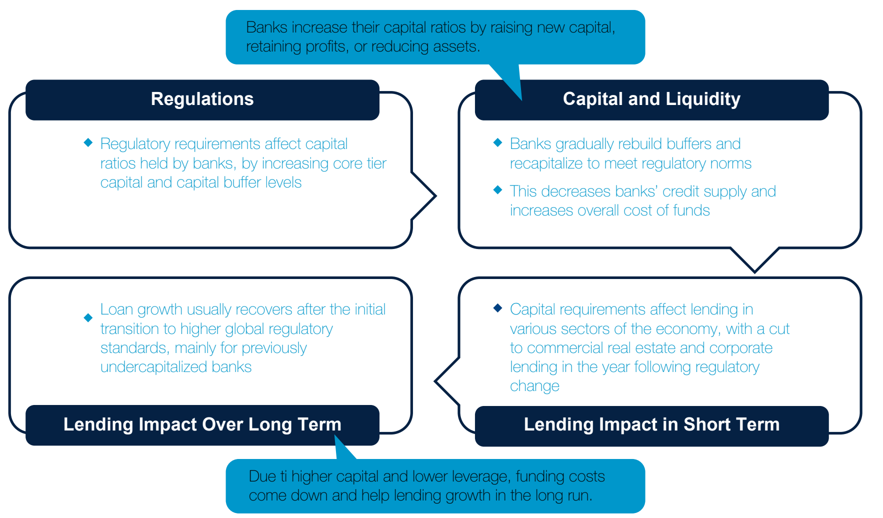
2.1 Impact on Lending Volumes

Impact in the Short Term: Lending volumes would be negatively impacted as banks try to lower high- risk-weighted assets from their portfolio. Higher capital requirements would affect lending on various sectors of the economy, with a cut in lending volumes to high-risk sectors, such as commercial real estate and corporate lending.

Regulations are directed at regulating excessive risk-taking by banks and thus impose more restrictions on credit lending by banks.

Impact in the Long Term: Gradually, as banks build up capital reserves in accordance with regulatory requirements and reduce high-risk-weighted assets, they would see a lowering of their cost of capital due to improved portfolio risk and a lower risk premium for high-quality assets. This would improve credit margins in the long run. Undercapitalized banks stand to gain as loan growth usually recovers in the long run on the back of an improved economy.

Exhibit 2: Regulatory Impact on the Lending Cycle of Banks



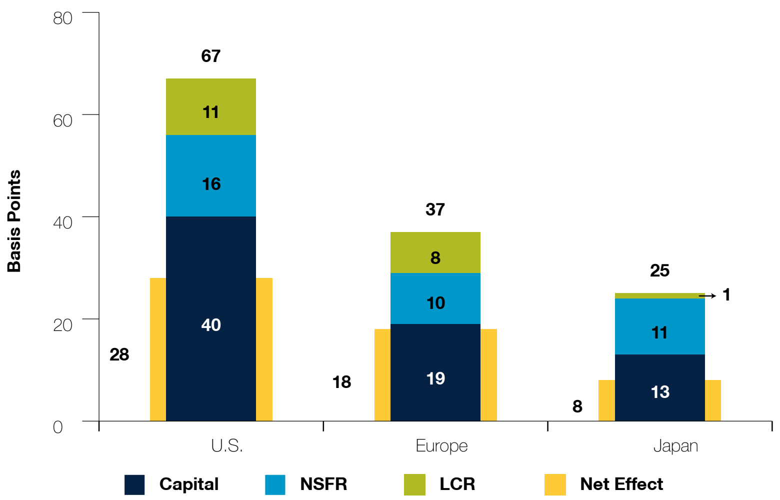
Source: Capgemini Financial Services Analysis, 2014; "Working Paper No. 486, The impact of regulatory requirements on bank lending", Bank of England, January 2014

Commercial banks would be less affected as compared to universal banks, while non-bank financial companies would remain largely unaffected. Non-banks would therefore have a competitive advantage over banks and can gain at the expense of large banks in the short run. According to the BIS estimates, the long-term economic impact of capital and liquidity requirements on credit growth is minus 66 basis points, while the impact on GDP growth is minus 8 basis points.[1]

2.2 Impact on Lending Rates

Higher capital and liquidity requirements have an economic cost and also impact the borrowing cost of funds for banks. The loan rates have to take into account the higher cost of capital and those of other sources of funding. The after-tax weighted cost of capital goes up as the proportion of equity capital rises in proportion to banks' overall assets. The effect of increases in risk-weighted assets is larger for U.S. than for European and Japanese banks, on average.

Exhibit 3: Impact on Regulations on the Lending Rates (bps), 2012



Note: Net Effect = Cumulative Impact of (Capital, Net Stable Fund Ratio (NSFR), Liquidity Coverage Ratio (LCR), Derivatives, Taxes and Fees) minus (Expense Cuts, Other Adjustments)
Source: Capgemini Financial Services Analysis, 2014; "IMF Working Paper, Assessing the Cost of Financial Regulation", International Monetary Fund, 2012

1 "IMF Working Paper, Assessing the Cost of Financial Regulation", International Monetary Fund, Douglas Elliott, Suzanne Salloy, and André Oliveira Santos, 2012

3 Banks' Response to Regulatory Reforms

In order to overcome the impact of tighter regulatory requirements in the aftermath of the financial crisis, banks have been resorting to asset sales, downsizing of non-core businesses, product-portfolio rationalization, and various other measures to improve their credit spreads.

Responses in the Short Term: In the years following the financial crisis and tighter regulatory requirements, banks have been forced to improve upon their operational efficiency and reduce the level of bad assets. Banks have limited their capital spending, disposed of their non-core assets, and undertaken measures decrease operational costs, such as reducing staff and closing unprofitable branches. For instance, Macquarie, Crédit Agricole and Royal Bank of Scotland have sold their non-core assets in order to focus on their core business.

Responses in the Long Term: Banks are undergoing transformational changes that will have significant long-term impact on their overall business efficiency. They have been taking steps to improve upon their business processes and discontinue high-risk products in an effort to reduce the overall level of portfolio risk. Banks are revising their interest rates and pricing structure so as to improve upon their product margins and offset some of the higher capital cost. Top global banks are building capital, liquidity coverage, and net stable funding ratios over the timelines provided by Basel III from 2014–2019.

While short-term changes are directed at meeting regulatory requirements, the long-run measures have to ensure sustainable growth.

3.1 Improving Operational Efficiency

As a tight regulatory environment continues to hamper sector growth, banks have been resorting to business and operational changes to lower their cost of business and improve upon their operational efficiency. Banks are restructuring their businesses by disposing of high-risk and non-core businesses and focusing on their core competencies. This will decrease the level of high-risk-weighted assets, and thus substantially reduce their capital requirements while also infusing fresh capital from sales. There have been ongoing mergers with other banks in order to bring economies of scale. Banks are also outsourcing most of their in-house IT operations, as well as maintenance of their IT infrastructures

3.2 Lowering Portfolio Risk

Banks are effecting product and process changes to reduce the overall level of portfolio risk. In order to reduce the risk inherent in loan portfolios, banks have cut back on commercial lending while expanding their exposure to the personal loans and retail housing segments. Furthermore, banks have begun exiting from the specialty loan servicing business, as the amount of capital holding against specialty lending has increased dramatically while providing only marginal returns.

Banks are simplifying their product portfolio and migrating complex products to simpler product types in an effort to reduce the level of risk and improve transparency. They are also gradually moving away from a product-centric selling approach toward a more customer-centric approach with a greater push to customer analytics. For instance, Citigroup is marketing its Simplicity Card, a credit card with no annual fee and no late fees.

3.3 Interest and Pricing Changes

Regulations have led to higher capital buffers and increased the burden of compliance on banks, which has increased the overall cost of funding for banks. To overcome the rising cost of credit, banks are now charging a higher rate of interest on lending while simultaneously cutting down the rates that they offer on deposits. This will enable banks to improve upon their lending margins, which have been under pressure in the current regulatory environment.

Banks are also adopting a risk-based pricing approach that allows them to charge a higher rate of interest for riskier loans depending on the creditor profile and usage history. In some cases, banks are altering terms and conditions of loan contracts disbursed earlier in order to reflect the higher cost of funds and also to reduce the probability of a credit default in accordance with tougher norms. Following this strategy, banks are trying to reduce their credit and default risk by repricing existing lending contracts.

4 Finding Regulatory Balance

In the aftermath of the financial crisis, the Basel III norms laid down the groundwork to reduce systemic risk by increasing the regulatory cushion in the event of a default and by placing more emphasis on risk management. Thereafter, new regulatory initiatives continue to emerge forcing banks to play a catch-up game with them. These regulatory reforms following Basel III are collectively hindering the ability of the banking sector to increase credit growth, thereby hindering the process of economic recovery. Moreover, the localization of regulatory requirements is hindering the ability of the banks to operate a sustainable global business model.

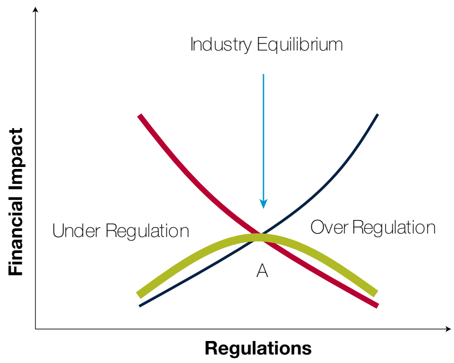
While a basic regulatory framework is important to support the growth of a sector and prevent malpractice, over-regulation can become a hindrance to sustainable industry growth, as is illustrated in Exhibit 4. The regulatory framework must therefore find industry equilibrium at Point A, which leads to maximization of industry growth in a given stable macroeconomic environment.

Regulations have to balance the need to reduce systemic risk while ensuring industry growth.

Exhibit 4: Regulatory Cost vs. Financial Stability

Under Regulation

- Banks indulge in high-risk lending to grow their topline
- In the event of financial crisis, it leads to bank bailouts using tax payers' money (and other negative economic and social consequences)



Over Regulation

- Higher than necessary cost is imposed on banks for compliance with excessive regulations
- Leads to restricted lending and declining returns for banks

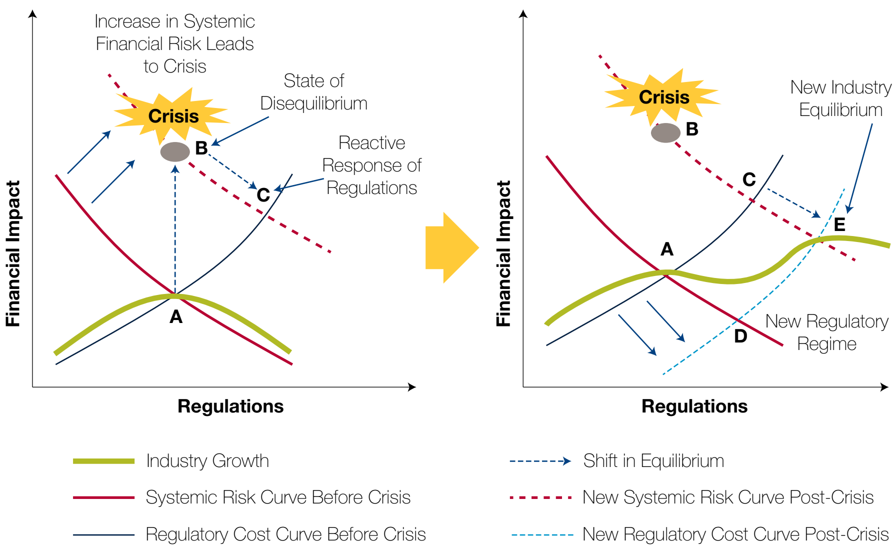
Industry Growth — Systemic Financial Risk — Regulatory Cost

Source: Capgemini Financial Services Analysis, 2014

However, over the course of macroeconomic growth, there are instances of financial crises that disrupt a stable macroeconomic environment, as was the case in the 2007 financial crisis. A financial crisis is usually the result of an increase in systemic risk due to various factors—such as increased risk-taking by corporations to improve shareholder profits, high levels of credit expansion in anticipation of a growing economy, entrance of too many new players into the market, selling of innovative financial products based on high risk-return, and greater inter-linkages in the rapidly globalizing world economy.

Regulations generally respond to crises reactively. That has been the case with the recent 2007 financial crisis, as depicted by Point B in Exhibit 5. As a result, the current regulatory environment can be termed as one of regulatory excess. This has distorted the overall macroeconomic environment leading to significant distortion of the costs imposed on banks, which are the engines of economic growth.

Exhibit 5: Finding Regulatory Balance



Source: Capgemini Financial Services Analysis, 2014

The current situation, therefore, is at Point C, characterized by a high degree of regulatory activity in response to the crisis. But Point C is sub-optimal for industry growth, as it drops to Point D. The regulatory environment therefore, has to self-adjust, by shifting to the right so as to prevent economic growth from falling to point D, and thereby find new industry equilibrium at Point E, which is higher than Point A. The regulatory environment thus self-adjusts to support a growing economy in a macroeconomic continuous cycle of booms and busts.

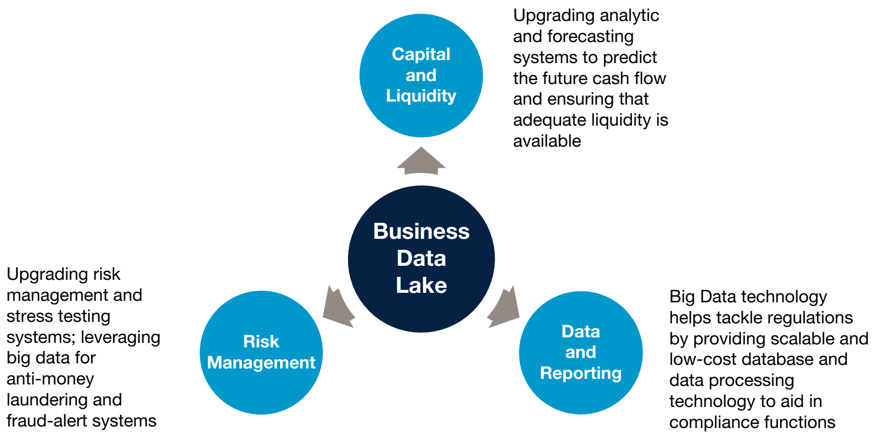
5 Regulatory Compliance via Business Data Lake

Given the current environment of significant regulatory risk to banks' operations, it has become imperative for banks to ensure that their systems are upgraded to meet new regulatory standards. Banks will have to embed regulations in their core business processes and use analytical rigor to tackle the existing high-cost complexity of regulations. But the challenge that banks are facing is that these changes in regulatory compliance are being led by different departments and groups belonging to business, regulatory and risk functions operating in silos and therefore failing to properly communicate with each other. This leads to an inconsistent understanding of the regulatory impact on the group, which brings considerable uncertainty into group-level decision-making.

Technology can help banks in better and faster processing of data, thus aiding in real-time regulatory compliance.

To ensure proper communication between various departments, the technology of Business Data Lake can offer significant advantages. This technology enables the business user to process big data from any data source in real time and leverage that data for analysis and insights, which can aid in real-time decision-making. The Business Data Lake technology helps integrate data across stand-alone systems belonging to business, reporting, and risk functions, and provides an enterprise-wide view of the data. When a new data source gets added to the environment, it can simply be loaded into the Business Data Lake, which helps in getting near-real-time analysis of the new data. Placing analytics on top of the Business Data Lake generates business insights, as well as regulatory and compliance reports.

Exhibit 6: Using Business Data Lake for Regulatory Compliance



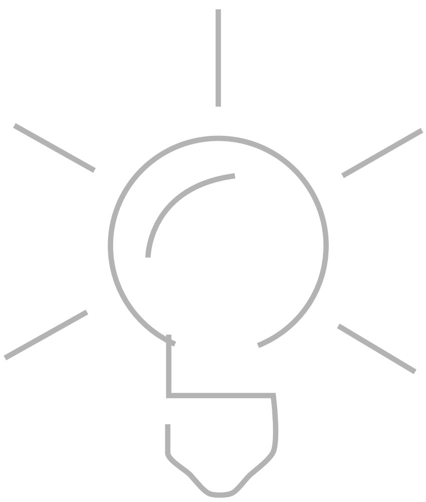
Source: Capgemini Financial Services Analysis, 2014; "Traditional BI vs. Business Data Lake – A Comparison", Capgemini and Pivotal, 2014

6 Conclusion

A number of recent regulatory reforms and various others in the pipeline regarding regulating capital norms, leverage ratios, and stress tests have created an uncertain industry environment for banks. The regulatory pressure is imposing a negative cost on banks, which is hampering credit growth of the sector and is preventing banks from taking part in a sustainable economic recovery.

The regulatory bodies therefore have to work toward creating a stable regulatory environment that will help banks in making business decisions. Banks should be advised by the regulators on how they manage their risks, while providing a basic regulatory framework that prevents excessive risk-taking by banks.

The regulatory regimes must find a balance between the need to maintain a sustainable pace of economic growth and ensuring that there is a free and fair environment for banks to flourish and support credit growth in the economy. At the same time, banks have to leverage new data processing technologies that can help them achieve near-time regulatory compliance to meet growing regulatory demands on the banks' IT systems.



References

1. “Regulatory Changes in the Investment Banking Industry”, Capgemini, 2013

2. “Working Paper No. 486, The impact of regulatory requirements on bank lending”, Bank of England, Jonathan Bridges, David Gregory, Mette Nielsen, Silvia Pezzini, Amar Radia and Marco Spaltro, January 2014

3. “IMF Working Paper, Assessing the Cost of Financial Regulation”, International Monetary Fund, Douglas Elliott, Suzanne Salloy, and André Oliveira Santos, 2012

4. “Traditional BI vs. Business Data Lake – A Comparison”, Capgemini and Pivotal, 2014. Also available at http://www.capgemini.com/resource-file-access/resource/pdf/pivotal_data_lake_vs_traditional_bi_20140805.pdf

5. “Evolving Banking Regulations, EMA Edition”, KPMG, February 2014. Also available at http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/evolving-banking-regulation/documents/evolving-banking-regulation-ema-2014-v3-fs.pdf

6. “Banks try to stay ahead of regulatory tide”, The Banker, Philip Alexander, January 2014. Available at http://www.thebanker.com/Regulation-Policy/Regulation/Banks-try-to-stay-ahead-of-regulatory-tide?ct=true

7. “An introduction to Basel III – its consequences for lending”, Norton Rose Fulbright, October 2012. Available at http://www.nortonrosefulbright.com/knowledge/publications/31077/an-introduction-to-basel-iii-its-consequences-for-lending

For more information,contact us at: **banking@capgemini.com**
or visit: **www.capgemini.com/banking**

Acknowledgements

We would like to thank **Rishi Yadav, Erik van Druten, Francis Hellawell, Ritendra Sawan, William Sullivan and David Wilson** for their contributions to this publication.

About Capgemini

With almost 140,000 people in over 40 countries, Capgemini is one of the world's foremost providers of consulting, technology and outsourcing services. The Group reported 2013 global revenues of EUR 10.1 billion.

Together with its clients, Capgemini creates and delivers business and technology solutions that fit their needs and drive the results they want.

A deeply multicultural organization, Capgemini has developed its own way of working, the Collaborative Business Experience™, and draws on Rightshore®, its worldwide delivery model.

Learn more about us at
www.capgemini.com

People matter, results count.