The regulatory opportunity

A Deloitte perspective on how financial institutions can move forward in a regulated world

In the years since the onset of the global financial crisis, financial institutions in Canada and around the world have been hit by a flood – tidal wave might be a more accurate description – of complex regulations. Canadian and foreign regulators have introduced new rules and regulations at an incredible pace. Many banks, insurers and other financial institutions (FIs) worldwide have scrambled to keep up.

FIs have responded to this wave of regulations by making significant investments in their risk, capital management and compliance infrastructures and by taking steps to strengthen their organization's risk culture. They've implemented more robust, comprehensive data systems in order to make better risk, business and compliance decisions. And they have begun to set aside much larger capital reserves to meet the demands of Basel III, OSFI requirements and other applicable rules.

No one can dispute the ultimate intent of these post-crisis regulations – it's hard to argue against protecting depositors and policyholders and ensuring the soundness and stability of the global financial system. Canada's regulatory environment has shown that it works very well during times of crisis; the question now is whether it creates a relative disadvantage for Canadian FIs during times of growth. Certainly, FIs themselves take issue with the burden they feel they shoulder because of the volume and complexity of regulation, and the impact of regulation on their ability to grow.

This regulatory burden is a common theme in our conversations with Canadian FI leaders. The cost of compliance is enormous, whether in terms of people, technology or infrastructure, not to mention the time spent on compliance activities across the organization. Rising regulatory capital requirements have become a significant constraint on the capital available for investment, putting downward pressure on returns amid softening growth prospects in such areas as mortgage lending. The challenge is especially acute for lower-tier FIs, who simply don't have the resources and expertise of their larger counterparts.

FI leaders commonly express a degree of frustration with the current compliance environment. The ground is shifting under FIs as rules are drafted, announced, tabled and revised. The regulatory signals aren't always clear, which makes it difficult for FIs to plan their next moves. Compounding the challenge is the fact that a number of Canadian FIs are subject to both domestic regulations and foreign rules e.g., the Volcker Rule in the U.S. Dodd-Frank Act, Solvency II and other regulations add more complexity and uncertainty.

Overall, however, the dominant attitude towards the regulatory environment seems to be one of resignation. FIs certainly accept the need to restore public trust and faith in financial institutions (though, to be fair, the reputation of Canada's financial sector was largely untarnished by the financial crisis) yet they regard the regulatory environment as simply a burden to be borne. For the most part, FIs respond to regulatory change reactively rather than proactively, and don't often consider its strategic implications.

The risk – either of overregulation or over reaction to regulation – is that FIs will retreat from global commerce and return to focus on domestic markets. Should FIs pull back from involvement in the global market, we'll see the global flow of capital fall. With less capital available from the world's top-tier institutions, innovation could be stifled (or at least slowed) in a wide range of sectors, while shadow banks and other, less regulated institutions step in to fill the void.

Time for an attitude change

We believe that by continuing to regard the current regulatory environment as a necessary burden, a price to pay for the industry's past failings, FIs are holding themselves back. Thinking about compliance as a "cost centre," or focusing on what regulations don't allow, inhibits FIs from uncovering potential new opportunities for business growth and operational improvement.

It's time to look at compliance – and the regulatory environment – in a new way. A strong compliance effort, rooted in a deep understanding of the regulations themselves, can potentially help organizations competitively differentiate themselves. The investments made to enable FIs to better understand their business, customers, risks and capital can be used to drive changes in how and where the organization operates in the years to come – up to and including its business mix.

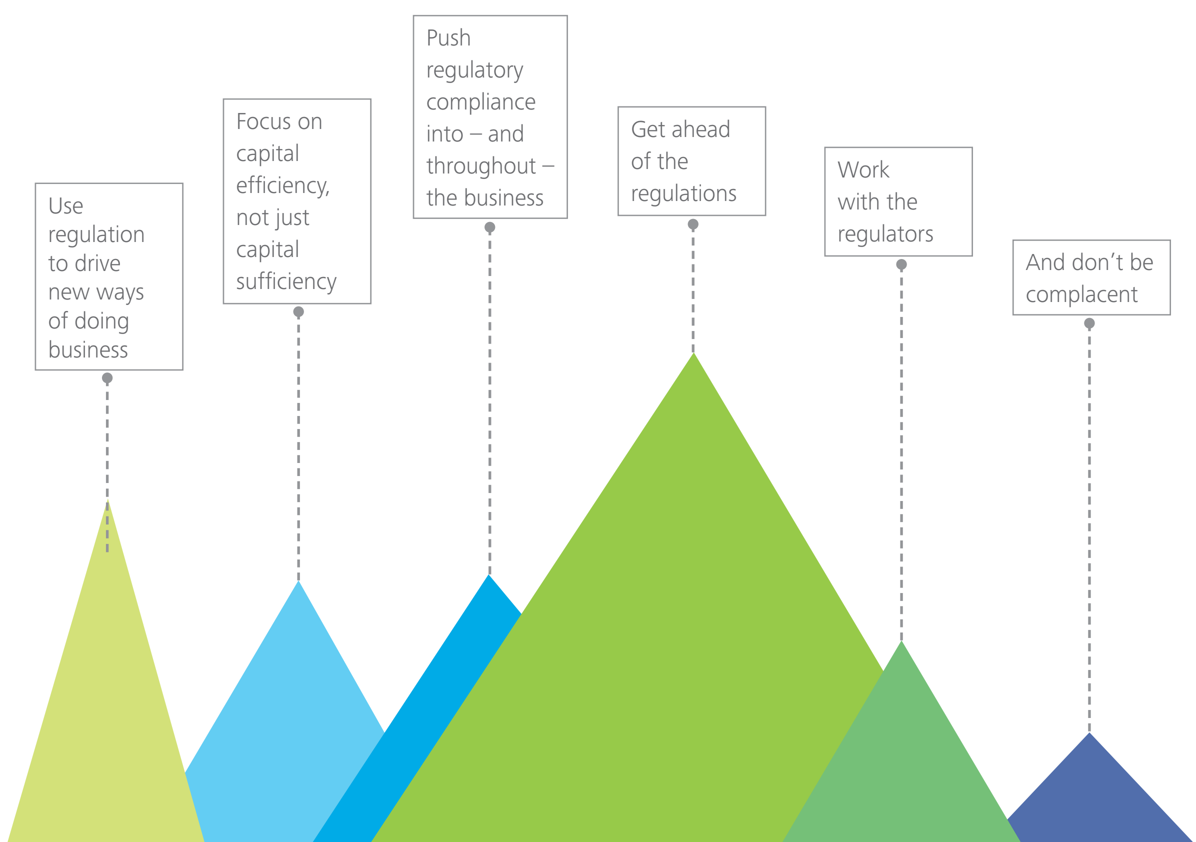
The significant investments FIs have made in recent years to meet stringent regulatory requirements have brought business benefits above and beyond their original intent. In building stronger regulatory, compliance, risk management and audit capabilities, FIs are gaining important new business acumen. True, costs have risen as compliance functions have grown – yet so too has FIs' ability to understand new regulations and how to innovate in this re-regulated environment.

FIs' investments in technology, driven in part as a response to regulatory pressures, are resulting in significantly greater data collection and analytics capabilities. These too can be exploited to provide FIs with an enhanced, enterprise-wide view of their businesses, risks and customers that will help them proactively avert potential problems – and identify new opportunities.

The pace and scale of regulation isn't likely to let up in the near future. As the post-crisis regulations continue to come into full force, banks and insurers can look ahead to additional rules and requirements in the not-too-distant future. FIs that take the initiative and strive to understand the impact of these new regulations on their business and develop a proactive response will be well-positioned to set themselves apart from – and even ahead of – their competitors.

Seizing the regulatory opportunity: Areas to consider

We don't believe it's naïve to encourage FIs to look for the upside opportunities inherent in today's regulatory environment. We believe that approaching regulatory change and compliance activities positively, with the upside in mind, is in FIs' best interests. Complex, voluminous and demanding regulations are here to stay, at least for the foreseeable future. FIs that get out in front of the regulations and use them to drive organizational change, economy, efficiency and effectiveness stand to create competitive advantages that could restart or accelerate their growth agenda.



1 Use regulation to drive new ways of doing business

Many FIs instinctively respond to new regulatory requirements tactically, doing what's required in order to achieve compliance. The necessary business data is collected, aggregated, analyzed and reported in the time and manner set out by the regulator. It's an understandable approach, perhaps, but one that does little to move the business forward: compliance activity is carried out on the regulators' behalf and little more.

Smarter organizations, in contrast, will take time to develop an in-depth understanding of the regulations and what they mean to the business. These FIs look not only for what might need to be scaled back or shut down, but also for what may now be permitted. A few years ago, a large European insurer, like its peers, faced the impending adoption of international financial reporting standards (IFRS). The company not only made sure it was ready for conversion to the new reporting standards, it also invested significant time prior to their adoption to truly understand what IFRS would mean to the business and, in particular, what the new standards would allow it to do. Because the organization understood the implications of IFRS so much better than their competitors, they were able to introduce new products and innovations that others simply hadn't even thought of.

2 Focus on capital efficiency, not just capital sufficiency

Much of the regulation introduced since the onset of the global financial crisis has focused on liquidity and capital sufficiency–ensuring that FIs set aside enough capital to prevent the sudden collapses or near-collapses that occurred during the recession. Since then, FIs in Canada and elsewhere have worked hard to meet the new capital requirements and will have to do so at least through the end of the decade.

As a result, FIs have less capital available for investment in their businesses and in growth opportunities. This reality is compelling Canadian FIs to also focus on capital efficiency – wringing every last bit of value from the non-regulatory capital available to them. Certainly, their peers in the U.S., Europe and elsewhere have focused on capital efficiency, in large part because they had little choice in the post-crisis era. The drive for better capital efficiency has pushed these FIs to actively reengineer their businesses – growing some business lines while getting out of others.

Canadian FIs, in contrast, have been less proactive in pursuing capital efficiency because they were not affected by the financial crisis to the extent many of their global peers were. Today, the situation has changed, and Canadian FIs should take a hard look at their businesses and determine whether it still makes sense to be as active in certain capital-intensive activities – or whether to retrench from or exit those businesses and focus more on fee-based businesses (such as wealth management) that provide stable, predictable revenue without consuming disproportionate amounts of scarce capital.

3 Push regulatory compliance into – and throughout – the business

Traditionally, FIs have approached compliance in "top-down" terms. Compliance activities are carried out separately from normal business operations, with limited interaction or engagement beyond what is required. It's an approach that creates little opportunity for business units to work together.

FIs should strive to make compliance-related activity simply part of "business as usual" by embedding these activities into the daily routine of their businesses. Incorporating regulatory compliance into business as usual will help make regulatory matters part of the day-to-day decision-making process across the organization, improving overall compliance.

4 Get ahead of the regulations

Embedding compliance activities into day-to-day business operations also means that FIs can redirect some compliance resources into developing a deeper understanding of the strategic impact of new regulations. This can help FIs gain insights into how regulations will affect customers, product offerings – even business models – and enable them to develop responses in advance of regulations coming into force. The result can be a powerful "first-mover" advantage to the firm that knows the regulations better than the competition.

5 Work with the regulators

Canada's financial sector has received many plaudits in recent years for its stability through the global financial crisis. Our FIs' long history of prudent business practices and cautious risk-taking is a significant contributing factor to this. So too is the fact that Canada's FIs and regulators have a respectful and productive working relationship, with little of the animosity displayed in some other jurisdictions.

This is a tremendous positive going forward. FIs and regulators share a common interest in ensuring Canada's financial system remains stable and secure, and that Canadians' best interests are served. Yet there is an important difference: regulators respond with rules to prevent past mistakes from re-occurring while FIs strive to anticipate and mitigate risks before they become problems. For this reason, we encourage FIs to communicate their insights and ideas before problems occur – and to work with regulators to develop mutually satisfactory solutions before they're needed, rather than after.

By working with regulators to develop new solutions and rules, FIs can bring to bear their superior understanding of their business. They can offer their insight into the most efficient and effective way to address issues and avoid cumbersome, costly and potentially less-effective regulation.

Attention, regulators: Focus on activities, not institutions

In the current environment, financial services regulations focus on the nature and complexity of the institution, not the nature of the activity. Yet this approach is not well-suited for the reality of modern financial services.

Today, many banks and insurers can operate in one another's traditional territory. Retailers, tech companies and other non-banks are entering the financial services market. And shadow banking activities, which are relatively unmonitored and unregulated, continue to increase.

A better solution is to develop regulations that focus on a given type of activity (e.g., complex derivatives and associated counterparty risk) and hold all organizations that provide that service to the same level of accountability. This approach would help to level the competitive playing field between firms of different types, standardize regulation overall – and, most importantly, ensure that the best interests of policyholders and depositors are protected amid a torrent of financial services change and innovation.

6 And don't be complacent

Some financial services watchers suggest that at some point, once the regulatory burden on FIs reaches a tipping point of sorts, the pendulum will swing back and some regulations will be scaled back. We caution FIs against adopting this viewpoint and using it to justify a "do just what's required" approach to compliance.

The world has changed since the financial crisis began. Governments and regulatory bodies will play an increased role in financial services for the foreseeable future – we simply won't be returning to the pre-crisis regulatory environment.

Instead, we urge FIs to embrace and understand the regulations in place – and the new ones on their way – to understand their strategic implications to the business. We encourage them to engage with regulators and offer their own insights into how to address issues and concerns proactively, and help shape the regulatory agenda in the years to come. FIs that can do this well will undoubtedly reap business benefits and competitive advantage.

For more information

Email us at cafinancialservices@deloitte.ca
or visit **http://www.deloitte.com/ca/financialservices**