

The New Landscape for Financial Services

Meeting the challenge of new regulation

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About the MCA and this report

The Management Consultancies Association is the trade body for the UK's management consulting industry. Between them, our sixty members employ 40,000 consultants, comprise 70% of the UK's £9bn consulting industry, and work with 90 of the FTSE 100 firms, including many firms in the financial sector, as well as almost all government departments.

This report draws on the expertise of our members to identify the likely regulatory changes, and set out how firms should respond to these challenges. The background provides a brief summary of the financial problems which the next round of regulation will seek to address. The report then goes on to explore the nature of this regulation, analyse the challenges this is likely to pose financial sector firms, and address how firms should best respond to these challenges. Finally, the report looks at how, in the face of these changes, the UK can maintain its current competitive position within the global market for financial services.

FOREWORD

The financial services sector has been a beacon in Britain's economy. But recent events, by common consent, have hurt it hugely. Now we must start its recovery.

The debate that is now underway about the regulatory response to the crisis in our financial markets and institutions will have a profound impact, both on Britain's ability to retain a pre-eminent position as an international financial centre, and on the effectiveness of our financial system as a catalyst for prosperity and growth. The Management Consulting industry supports many of the initiatives that have been taken; we believe that the crisis exposed serious weaknesses in our financial companies and the regulatory regime.



As we suggest in this paper, our financial sector is experiencing a massive crisis of trust and confidence that must be addressed. Too many in the sector still appear to be 'in denial'; they seem to assume that life will return to normal once the immediate impact of the crisis is over. Our strong view is that they are wrong. The long and, often, painful process of renewal must be joined. The alternative will be ever greater demands for more intrusive and costly regulation, with the loss of the drive and innovatory spirit that, at its best, makes financial services an engine of growth and excellence.

The challenges that the anticipated reforms will pose are likely to be as great, if not greater, than the difficulties already experienced. As this MCA report argues, many firms are poorly equipped to respond effectively. They often lack good governance, processes and key skills. IT systems may need updating, and frequently need work so that they can deliver to their full capability. And financial institutions must, while undertaking all this work, ensure that standards of customer service continue to rise. Firms that neglect their customers will be punished in the marketplace.

And the scale of these difficulties is made worse by the cloud of uncertainty that remains over much of this agenda. The recent apparent tug-of-war between the UK regulatory authorities has harmed the sector and Britain's reputation. We also anticipate further changes and initiatives from the EU and other international organisations. Current domestic political uncertainty, with the possibility that a new government might reopen many issues, means that firms must plan for further change as well as immediate reform. Our plea is that the authorities move as quickly as possible to secure an improved and stable regulatory environment; this is one of the ingredients that we will need if trust and confidence are to return.

A handwritten signature in dark ink, appearing to read "Alan Leaman". The signature is fluid and cursive.

Alan Leaman
Chief Executive
Management Consultancies Association

Executive summary

The credit crunch has permanently changed the financial sector; and the regulatory response will cement and, in some cases, extend these changes. In June, the Obama administration set out its proposals for overhauling America's regulatory system; in the UK, after months of debate in which all parties – from the Bank of England and the FSA to private equity and hedge funds – have pleaded their case, the Treasury has now released its White Paper on reform of financial sector regulation, and the Conservatives are set to follow suit with their alternative white paper. The coming months will see further regulatory reforms from national and supranational bodies, such as the EU, as authorities attempt to avoid a repeat of the crisis.

Crises are often the catalyst for far-reaching change, and this one is unlikely to be any different. From business models to executive remuneration, financial sector firms will find their activities being increasingly scrutinised and challenged by more intrusive regulators. This is a massive crisis of trust and confidence in our financial system in general, and in individual financial institutions in particular. Its scale is probably still not appreciated adequately by those with responsibility for putting it right. Given the origins of the crisis, new regulation seems likely to put liquidity and capital controls squarely under the spotlight; however, there will also be substantial changes to the level of transparency expected of financial sector firms, as well more stringent requirements of their non-executive directors.

Adjusting to the new regulatory requirements will pose financial sector firms a series of challenges. Measuring risk accurately will demand vastly improved data management capabilities, and managing it effectively will require improved governance and risk-mitigation structures and processes. Dealing with a more intrusive regulator will also impact on firms' working practices. To respond to these challenges, firms will need to adapt their training and recruitment programmes to ensure that they have the right skills mix within their organisation. Yet whilst making the changes required by the new regulations, firms will also face the added challenge of remaining cost-efficient, maintaining performance levels and meeting the needs and expectations of their customers. The challenge will be exacerbated by the emergence of new competitors as new firms enter the market as start-ups or from other sectors.

Challenges	Solutions
Getting governance right	Voice of risk needs to be represented in the boardroom; set up regularly-convened risk committee.
Developing risk mitigation structures	Elevate the role of the risk professional; employ non-executive directors with relevant financial experience; rethink allocation and pricing of internal capital; make greater use of more sophisticated stress-tests; use risk-based rather than competitive pricing for products; use pay structures (such as S-curves or the bonus/malus system) consistent with long-term stability of the financial sector.
Improving data-management capabilities	Involve the CIO from the outset in developing new systems; collect information on an enterprise-wide basis; employ systems which can configure this information at the click of a button to suit the organisation's and regulator's needs; ensure that this information becomes integral to firm's decision-making process.
Achieving the right skills mix	Identify the new skills (such as risk management) required by the regulatory agenda; tailor recruitment and training programmes to match these needs.
Dealing with the regulator	Involve the regulator early; ensure that an individual is responsible for and has oversight of all of the firm's interactions with the regulator; ensure that the regulator receives "one version of the truth". Employ staff conversant with the regulator's modus operandi.
Coping with new competitors	Insulate brand from damage of financial crisis; invest in innovation; focus on customer's evolving needs and expectations.
Remaining both cost efficient and compliant	Get the architecture of the response right: ensure that projects are properly co-ordinated and that there is no duplication; focus on outputs; understand which parts of the business add the most value – and focus on these; rebuild trust in the sector; focus on customers.

But at the same time, the UK needs to ensure that the regulatory changes do not diminish the international competitiveness of its financial sector and the attractiveness of the UK as a financial centre. This means ensuring that the UK's voice is clearly heard in the relevant international forums, such as the EU, so that supranational legislation does not damage British interests. It also means ensuring that other factors which make London an attractive place to do business are maintained: a diverse, international talent pool; a competitive tax regime; good infrastructure; and, importantly, a stable business environment.

Introduction

The landscape has changed for financial services. As the banking crisis eases, it will be followed by a wave of regulatory changes for the financial sector. Much effort has already been spent on debating what these new rules should be. In March, the Turner Review analysed the problems which led to the crisis and suggested various reforms, and Sir James Sassoon produced a review of the Tripartite System on behalf of the Conservative Party. These were followed in May by a report from the Financial Services Global Competitiveness Group outlining its vision of the future of financial services in the UK, and the EU's announcement that it intended to create a European Systemic Risk Council as well as a super-committee of regulators in response to the de Larosière report. Picking up on this in June, the House of Lords European Union Committee published a report on the future of EU financial regulation and supervision, and the Treasury has now published its long-awaited White Paper on strengthening regulation of the financial sector; on July 16 the Walker review on corporate governance was published; and the Conservatives have also promised their own alternative white paper on financial regulation.

Crucially – in contrast to previous rounds of regulatory turbulence – many firms do not currently have spare cash to implement the next set of changes; yet they will be dealing with a regulator more resolutely committed to implementing far-reaching change than at any time in recent history. The challenge, then, facing the financial sector is how to make the impending mandatory changes whilst maintaining current levels of efficiency and customer service, and coping with a sharp recession. This does not merely mean dealing with reduced revenues: recessions are often the catalyst for a wave of innovation and the birth of new firms. The current recession is likely to see new players entering the financial sector, increasing the competitive pressures on existing firms and their market share.

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Background

Much effort has been spent in analysing what led to the credit crunch. Andrew Haldane, from the Bank of England, recently presented a paper arguing that the massive returns enjoyed by banks during the bubble, and the subsequent slump, could be explained by increased leverage.¹ Lord Turner, the Chairman of the FSA, set out his organisation's understanding of the causes of the current crisis in his Review in March. Since this understanding will inform the FSA's attempt to address these problems through the next round of regulation, it is worth briefly summarising the FSA's position.

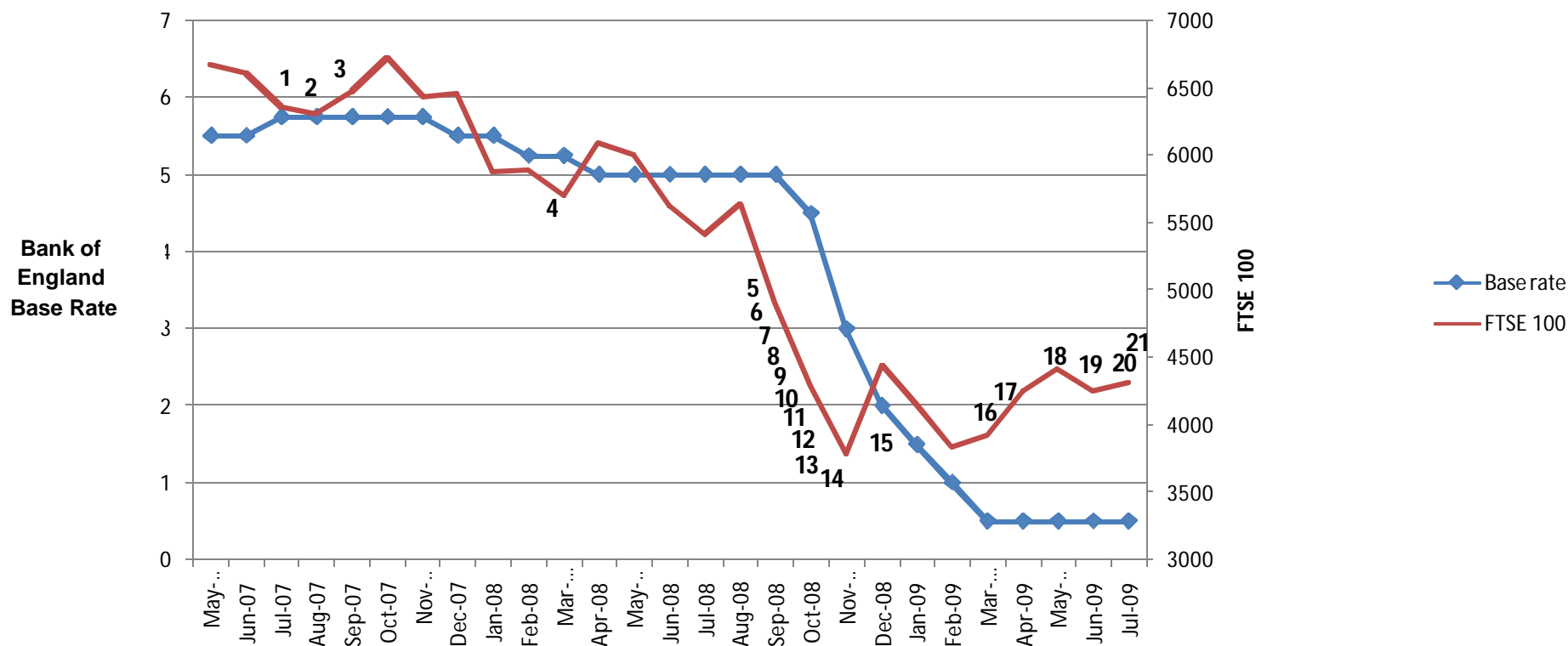
In his speech at *The Economist's* inaugural City Lecture in January 2009, Lord Turner took macro-economic imbalances as the starting point of his analysis.² Very high savings rates in developing economies such as China, in combination with fixed exchange rates in these countries led to a massive accumulation of central bank reserves, a very high proportion of which were invested in the government bonds of developed economies. This depressed yields on these government bonds, with two significant consequences: first, it fuelled a rapid growth in the extension of credit in some of the developed countries issuing this debt, notably the USA and the UK; second, it led investors on a "ferocious search for yield".

This search, in turn, spawned a generation of innovation in the financial sector which was focused on the origination, packaging and distribution of securitised credit instruments. The explosive growth in the scale and complexity of credit securities was supported by and also fuelled big increases in the leverage of financial institutions, allowing them to expand rapidly. This growth, according to Turner, soon mutated into a self-fulfilling cycle of falling risk aversion and rising irrational exuberance, in which falling credit spreads and volatility prices drove up the current value of a variety of instruments marked to market on the books of banks, producing higher apparent profits, and reinforcing traders' and managers' conviction that they were onto a winning strategy. This did not prove to be the case, and the bubble burst when it transpired that many of the beneficiaries of a decade of reckless credit extension would be unable to repay their loans. With the collapse of Lehman's in September 2008, liquidity vanished from the money markets leaving many institutions unable to finance short-term debt and facing collapse.

¹ Andrew Haldane, 'Small lessons from a big crisis' Bank of England, <http://www.bankofengland.co.uk/publications/speeches/2009/speech397.pdf>

² Adair Turner, 'The financial crisis and the future of financial regulation' Financial Services Authority http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml

Financial Services Crisis Timeline



- 1. By summer 2007: American housing market goes into free-fall; banks cut lending.
- 2. August 9: EU Central Bank and Federal Reserve inject \$90bn into money markets
- 3. Sept 14: Run on Northern Rock
- 4. Mar 14, 2008: Bear Stearns bailout
- 5. Sept 6: US Treasury takes over Freddie Mac and Fannie Mae
- 6. Sept 14: Bank of America takes over Merrill Lynch
- 7. Sept 15: Collapse of Lehman Bros

- 8. Sept 16: Bailout of AIG
- 9. Sept 17 Lloyds and HBOS merger
- 10. Sept 22: Morgan Stanley and Goldman Sachs become regulated banks
- 11. Sept 28 Nationalisation of Bradford and Bingley
- 12. Oct 3: US passes TARP
- 13. Oct 8: UK launches £500bn banking bailout
- 14. Nov 25: UK announces £20bn economic stimulus package; US announces \$800bn economic stimulus

- 15. Dec 12: EU launches €200bn stimulus package
- 16. Mar 9: 2009; Sir James Sassoorn's Tripartite Review
- 17. Mar 18: Turner Review
- 18. May 7 UK begins quantitative easing programme
- 19. Jun 17: Obama regulatory proposals; Mervyn King Mansion House speech
- 20. July 8: Treasury White Paper
- 21. July 16 Walker Review published

The difference between this cycle of boom and bust and its predecessors, however, and the root of its extraordinary severity, was the role played by securitised credit instruments. One of the initial arguments in favour of securitisation was that it would reduce risks for individual banks by passing credit risk to end investors, reducing the need for unnecessary and expensive bank capital. Risk would be more evenly spread throughout the system. However, this did not happen. Instead, rather than being sold to end investors, these credits were either bought by other banks, or the original bank retained some of the risk through the use of credit derivatives. Thus the risks remained on the balance sheets of banks, but in a more complex and opaque form. When the sub-prime crisis hit, banks were unaware of and unable to discover their exposure to assets which were being written down, and, since markets had seized up, unable to value the assets they could identify.

However, Turner's point is not merely about mistakes arising from ill-conceived trading strategies. He goes on to suggest that greater systemic risk is inherent in the securitised credit model. This is because banks are highly leveraged entities which perform maturity transformation and are thus exposed to liquidity risk; irrational swings in the price of credit securities held by banks, and thus in their capital resources, are likely to be more damaging to the economy as a whole than irrational swings in the price of equity held by end investors.

What will the next wave of regulation entail?

This diagnosis suggests certain areas for new regulatory activity. One is the macro-economic imbalances which have developed in the last decade; however addressing this is far beyond the scope of an individual regulator, although there will, without doubt, be greater cross-border cooperation between regulators in future. Other obvious targets are risk management, securitisation and its lack of transparency, and banks' and near-banks' liquidity and awareness of it.

The Turner review is, of course, not the only attempt to draw lessons from the causes and consequences of the financial crisis. On behalf of the Conservative Party, Sir James Sassoon took a slightly more structural approach, looking at the roles played by the Bank of England, the Treasury and the FSA in regulating the financial sector, and considering the case for amending this arrangement. The Walker Review on corporate governance in the banking industry (since extended to cover other financial institutions as well), by contrast, focuses on the arrangements and governance within firms. In his speech at Mansion House on June 17, Mervyn King, the Governor of the Bank of England, set out his views on the radical changes necessary to prepare the UK's financial sector for future challenges. On July 8 the Treasury published its White Paper on *Reforming Financial Markets*, which largely accepted Turner's recommendations for reform, whilst also eschewing any significant alteration to the Tripartite System.

From this debate about what regulation will be needed in future, the following themes have emerged:

i. Capital and Liquidity Controls

The FSA and Treasury have both made clear – and there is general consensus – that tougher rules surrounding capital and liquidity requirements will be central to future regulation. However, to avoid excessive regulatory arbitrage, the Treasury argues these will need to be implemented on an international, rather than merely national basis.

The Turner review called for “the quality and quantity of overall capital in the global system [to] be increased” resulting in minimum regulatory requirements significantly above the existing Basel rules. Counter-cyclical capital buffers will need to be built up during economic upswings; significantly more capital will be required against all high risk activities; and the dangers of excessive growth may be addressed by the introduction of a maximum gross leverage ratio (the ration of a bank's debt to equity), which takes into account all risks both on- and off-balance sheet. Furthermore, systemically important banks will be required to hold more capital. In the longer term, changes to the Basel regime are likely to lead to a review of rules surrounding banks' capital adequacy.

Liquidity monitoring will feature more prominently than previously, with regulators far more closely involved in scrutinising individual banks' liquidity positions. This new regulatory rigour may also be supported by the introduction of a core-funding ratio to ensure sustainable funding of balance sheet growth.

ii. Greater Financial Transparency

There have been calls within the EU to force hedge funds to disclose their trading strategies.

As far as products are concerned, derivatives markets will be more tightly policed. Credit default swaps will be traded via systems with clearing and central counter parties. More information about securitised products, such as disclosure of ultimate legal ownership, is likely to be required.

In its annual report, the Bank for International Settlements recommended that financial products should be regulated like medicine on a clearly-defined hierarchical scale, topped by the safest products, which should be available to all, and tailed by those financial instruments that are illegal.

iii. Governance and tougher vetting of approved persons

The FSA has already stepped up the rigour with which it scrutinises Significant Influence Functions, (individuals who are key decision-makers within financial sector firms), vetting them for financial competence as well as probity. This process is likely to be broadened to include a wider number of positions within firms.

This issue is also addressed by the Walker Review, published on July 16, which called for non-executive directors to spend at least 30-36 days per year on this role and argues that chairmen should devote at least two thirds of their time to bank business. Risk committees should be beefed up; this means being chaired by a non-executive director and being given the power to block big transactions. The chief risk officer should report both directly to the CEO and to the board risk committee.

iv. Remuneration

Remuneration policies will be required to match the long-term strategic interests of the economy as well their firm and promote stability within the financial sector. The FSA expects this to be achieved by the "development and enforcement of UK and global codes." Despite fears in the City of drastic interventions, such as pay caps, the Treasury's White Paper restricted itself to recommending that the FSA develop a code of conduct for remuneration by next February, and then report annually on whether or not firms are complying with its principles. The Walker Review went slightly further, calling for bonus payments to be deferred for at least three years until the performance of the assets to which they relate has been established, and for banks to publish details (although not the identity) of high earners. Proposed EU regulation, due to be enacted in 2011, may have sharper teeth; under plans announced on July 13th, banks whose pay policies encourage risk could be penalised.

v. **Enhanced FSA scrutiny of financial sector firms' activities**

The FSA will complete the implementation of its Supervisory Enhancement Programme, which will give it powers to conduct more intrusive scrutiny of a wider range of financial sector firms. This will entail a “major intensification of the role the FSA plays in bank balance sheet analysis and in the oversight of accounting judgements”, and will require firms to provide the regulator with more detailed information more frequently. The FSA’s focus will be on business models, strategies, risks and, above all, outcomes, rather than on systems and processes, although the FSA’s new rules will, of course, indirectly have a huge impact on these.

vi. **Greater collaboration between regulatory authorities**

The Turner Review calls for the establishment of colleges of supervisors for the largest and most complex international financial institutions as well as a new European institution with independent regulatory powers; this should be accompanied by increased national powers to require subsidiarisation or limit retail deposit taking. On May 27, responding to the de Larosière report, the EU Commission announced plans to create a European Systemic Risk Council, which would provide early warning of possible risks, and a European System of Financial Supervisors, a super-committee of regulators from across the European Union.

vii. **Reform of credit ratings agencies**

The Turner Review calls for a “fundamental review of the use of structured finance ratings”. Agencies are likely to be subject to registration and supervision. They will be expected to apply ratings only to securities for which a consistent rating is possible; and to make clear that ratings refer to credit risk, not market or liquidity risk.

viii. **Financial Services Compensation scheme**

In the event of future bank collapses, banks will need to be able to provide detailed information about all retail deposits to ensure that a set proportion of these can be protected. The Treasury’s White Paper expects the FSA to work with “high impact” firms to ensure that their legal structure facilitates resolution in case of a collapse, and also proposes that from 2012 banks should pay a levy to pre-fund the Financial Services Compensation scheme.

“Over the past few decades, there was a trend towards separating out strategy, risk, finance and compliance functions from managerial line responsibilities into supporting roles, leaving line managers to devote their time to operational processing. This has resulted in lack of accountability and expertise for risk management within the line. In future, this trend will need to be reversed, so that risk management and accountability are embedded into the job description of managers and integral to their incentivisation. In addition, cross-organisational process owners will need to be created so that there is an individual who is personally responsible for considering the end-to-end process and ensuring risk is properly monitored and controlled for the process.”

Andrew Stewart, Navigant

ix. Bank structure and size

In his speech at Mansion House on June 17, Mervyn King called into question the wisdom of allowing commercial banks with deposits guaranteed by the taxpayer to engage in investment banking. He also suggested that: “If some banks are thought to be too big to fail, then, in the words of a distinguished American economist, they are too big”. Whilst the current government does not accept this view, a future Conservative government, if elected, would be more likely to review, for instance, the gigantic bank created by the merger of Lloyds TSB and HBOS. EU competition authorities have also indicated their concerns about the UK banking market.

These regulatory changes may be accompanied by institutional changes to the tripartite system. This will add an element of uncertainty; policy details may be expected to vary as new individuals begin to implement new rules according to new frameworks. It is important, therefore, that political parties take care to set out their plans for the financial sector as clearly as possible in order to minimise this uncertainty, and ensure that time wasted planning for conflicting eventualities is minimised.

What challenges will the next wave of regulation pose?

This wave of regulation will have far-reaching consequences for financial sector firms, and require new thinking about old assumptions in all areas of firms' activities. Challenges will be both strategic and performance-related and will include:

i. Getting Governance right

Firms will need to adjust their governance arrangements to ensure that risk is taken seriously; the firms that have come through the crisis better than others are those that had already done so. Boards will need to ensure that high risk activities are kept in check and an individual will need to take on the role of being the voice of risk in the boardroom. Below board level, there will need to be a regularly convened (e.g. weekly) risk-committee. Responsibilities for overseeing and mitigating risk will need to be clearly allocated, and those tasked with these roles will need to ensure that they cooperate effectively with one another to achieve this.

ii. Developing new risk-mitigation structures

At the heart of the recent crisis was a catastrophic failure to identify, measure and manage risk. Firms have already begun to reassess their risk-mitigation structures, and the changes will need to be radical. Risk mitigation will need to be embedded in the culture and architecture of firms: the role of the risk professional will need to be elevated, and governance structures will need adjusting so that non-executive directors have the necessary expertise to question the board over high risk strategies.

Financial sector firms will also need to review their legal structure – often the product of organic growth rather than an overarching strategy; this will mean thinking again about where they allocate internal capital and how they price internal funding, taking into consideration the capital intensity and risk profile of various activities. In future, risk capital may be deployed outside the banking sector to a far greater extent than within it.

New risk controls and procedures will have to be developed, not just for the core Basel 2 areas of market, credit and operational risk, but also for liquidity risk. Greater use will need to be made of (tougher and more sophisticated) stress-tests, which take into account the possibility of even the most unlikely scenarios.

There will also need to be greater transparency around products; firms will have to consider using risk-based pricing in preference to purely competitive pricing, and systemic as well as firm-specific risk will have to be factored in.

Finally, firms will need to ensure that their remuneration structure does not encourage short-term risk taking in pursuit of transient profit, but are instead consistent with long-term financial stability.

iii. Improving data management capabilities

Risk-adjusted remuneration, of course, only works if risk is being adequately calculated and reported; the last year has shown that inability to do this is the Achilles heel of many financial sector firms. Indeed, Andrew Haldane, of the Bank of England, described “informational failure” as the “unifying theme” of the crisis.³ Central to developing the capacity to monitor risk adequately will be creating information and reporting systems which can generate and manage reliable data about firms’ operations, and provide it to front-line decision-makers. The regulator, too, will expect clearer, comparable data from all firms.

Incremental rather than strategic change has led to a mish-mash of different information systems. With the regulator demanding “one version of the truth”, as well as much more detailed information about capital and liquidity risk on a more frequent basis, it will be necessary for firms to radically improve performance in this area. Comprehensive information (i.e enterprise-wide, rather than information segmented by country or unit) about a firm’s risk exposure will need to be available (and transmittable) at the press of a button, and will have to be readily configurable in the Chief Information Officer’s office to suit the organisation’s needs. Scrutiny of this enhanced data will then need to become integral to the firm’s decision-making processes.

The role of the CIO will grow in importance; it will be crucial that firms involve the CIO in this process from the outset, so that the implications and scale of radical changes to information management systems are properly appreciated.

In some firms, these changes will need to be juggled with the backlog of systems-integration accumulated through previous mergers or regulation.

“FSA-authorized firms are bracing themselves to tackle a blizzard of new and emerging regulatory requirements - not only in response to the global financial crisis but also as a result of changes that had been instigated some time ago. Important initiatives include the Payment Services Regulations, the Banking Conduct of Business, the new Liquidity Regime and associated reporting, and the FSA Supervisory Enhancement Programme. When implemented, many of these will affect the same organisational units, business processes, computer systems and governance arrangements as well as interacting with each other. Therefore, the creation and mobilisation of an integrated and well defined portfolio of projects that delivers the necessary regulatory change will undoubtedly be achieved more effectively and at less cost than would be the case if each one were dealt with separately.”

Bernie Levins, PIPC Global Project Solutions

³ Andrew Haldane, op cit, 1

iv. Achieving the right skills mix

These changes will have implications for the skills mix required by firms. They will need to adjust their recruitment and training programmes accordingly to ensure that their employees have the skills and expertise necessary to thrive in the new financial landscape. Risk functions, in particular, will need to be filled with individuals with the requisite analytical and technical skills. This will not be cheap, as such employees will be in high demand.

v. Dealing with the regulator

Firms will also need to incorporate a more intrusive regulator into their daily practice of doing business. The number of points of contact between firms and the regulator are likely to multiply, and firms will need to ensure that someone has clear oversight of these interactions, as well as overall responsibility for managing and coordinating the relationship, and ensuring that the regulator receives “one version of the truth”. It will be important for firms to involve the regulator early in changes to their organisation to ensure that changes lead to compliance rather than confusion. Firms will also need employees conversant with the FSA’s way of working who can communicate their activities to the FSA in a way that fits in with the FSA’s approach.

vi. Coping with new competitors

Recessions can be the catalyst for enormous changes and often spur waves of innovation. In the financial sector, widening mortgage spreads and the state of flux following the crisis means conditions are now ripe for new entrants from other sectors often with strong brands untainted by the errors and excesses which led to the crisis; the Treasury’s White Paper aims to remove the barriers to entry to the financial sector. A flood of new firms, from boutique hedge funds to specialist life-insurers, will help create an increasingly competitive environment. And at the same time, two of the largest competitors in the financial services market are currently state-owned. Firms will need a way to distance themselves from the negative associations of the financial crisis, and maintain shareholder-value; those prepared to make the strategic choices to invest in innovation or in acquiring distressed rivals can emerge with their position enhanced, even as others go to the wall.

"While clearly there is a critical challenge to ensure compliance with the wide range of new legislation and the material issues the current market conditions create, it is also important that institutions do not forget to look at their competitive positioning, rise to the challenge of the new entrant competitors in their sector and examine the opportunities that exist to gain advantage over weaker competitors."

Nick Sandall, Deloitte

vii. Remaining both cost-efficient and compliant.

These challenges are not small, especially for larger organisations. Firms will have to balance tight budgets and available senior management time between developing the new structures and processes demanded by an increasingly resolute regulator, rebuilding balance sheets and maintaining customer service and retaining customers – a challenging task with historically low interest rates squeezing banks' deposit margins. Banks will need to prioritise and decide which costs can be passed on to the customer – but at a time when government stakeholders in banks are reviewing the level and justification for certain fees routinely charged by banks.

And while dealing with these challenges, banks will also need to complete the implementation of recent Directives such as Payment Services, and Banking Conduct of Business, which have not yet universally been adopted.

“With increased pressure from the latest regulations cascading onto operational processes and the inevitable increase in pressure from demanding (and less loyal) customers who will shop around even more for top quality service, there will be a real focus on operational excellence. Legacy process and systems shortcomings will have to be addressed with the aim of providing fast high quality outputs at minimum operating cost. With tight budgets, exploiting self funding performance improvements will be high on the list of priorities.”

Tim Washington, Bourton Group

How can financial services firms respond to these challenges?

In order to navigate their way successfully through this jungle of conflicting priorities, managers will need to display great leadership and clarity of purpose. These are some principles that will help:

i. Get the architecture right

The coming wave of regulation will have an impact on all areas of organisations, and responding to this will be an immensely complex process. In leading this response, CEOs will need to set out a clear vision for achieving these changes in a structured fashion, maximising coordination and avoiding duplication. Without such leadership and vision, there is a danger that individuals within firms will focus only on implementing the changes relevant to their area of business without any consideration of the bigger picture. Given the possibility of a change of government in the near future, however, and the prospect of new regulations emerging from the European legislative process, this roadmap will also need to be flexible and adaptable enough to adjust to new requirements as they materialise.

ii. Focus on outputs

Over the next couple of years, firms will be challenged to implement a raft of changes. Given the scale and complexity of some these changes (such as reorganising data management processes), and the large sums of money that such projects could cost, it is important that executives know exactly what they want to get out of these changes and take steps to ensure that the process is managed accordingly. Clearly defining outputs will not just mean understanding the firm's own needs, but also engaging the regulator at the beginning of the process and remaining in contact for its duration to ensure that changes are in accordance with regulations. Taking steps to ensure that these outputs are achieved will be a multi-faceted exercise, ranging from ensuring that controls are in place to guarantee that the project continues according to plan, to ensuring that the organisation has employees with the right skills and expertise to follow it through.

iii. Understand which part of their business adds the most value

Firms should focus on those core operations where they have a competitive advantage, and also consider the relative capital intensity of their various activities. Capital-intensive activities in markets in which firms do not enjoy a competitive advantage may be worth abandoning. Similarly, if the cost of complying with new regulations in non-core areas is high, these activities could be dispensed with. Non-capital-intensive activities such as advisory work may prove an attractive alternative.

iv. Rebuild trust

Banks will need to start rebuilding the public's trust in the sector. This can be done in part by repaying the taxpayers for the stakes they took in the banks in the depths of the crisis, as well as by fulfilling their crucial role in helping the economy to recover, by ensuring that they lend responsibly to those individuals and businesses best equipped to benefit from these loans.

v. Focus on customers

Another step towards rebuilding trust is putting the needs of the customer first. Unlike many other things, consumer expectations do not fall in a recession. Although it is now more complicated for banks to create mortgages, this does not mean customers will be happy queuing in a branch while these issues are thrashed out. Firms which succumb to the temptation to focus only on short-term survival risk losing customers in the long run. To avoid this, it will be necessary to provide customers with rewards in the medium term. Firms should balance short-term fire-fighting needs against the longer-term imperative to maintain their market share.

“Firms should not look at the next round of regulations as simply a compliance exercise. Indeed for first movers, compliance will provide competitive advantage through comprehensive enterprise-wide data availability and real time information delivering increased reliability and accuracy to strategic, tactical and risk sensitive management decisions. All of which combine to deliver shareholder value through; increased brand strength and market perception, public confidence, profitability and ultimately leading to a outperforming share price.”

Adam Woodhouse, Xantus

Maintaining the UK's position within the global financial order

Despite much talk of decoupling, modern business – and modern finance – is global. One of the remarkable aspects of the current crisis is that what started as a problem in the American sub-prime market has quickly spread to hit economies across both the developed and the developing world. Of the 600 banks based in London, 420 are European. In this era of increasingly interlinked global commerce, markets are bigger than nations. Attempts to resolve problems which have their roots in part in international macroeconomic imbalances are bound to have an international as well as a national dimension.

It is crucial, especially given the role played by the financial services sector in the British economy, that Britain takes the lead in re-shaping the international regulatory agenda. Enhanced European regulation of the financial sector, and an enhanced role for a European regulator, are possible outcomes of the recent crisis. Given the differences between the European and British approach to financial firms and their products, and the clear asymmetry between British and European interests in any tightening of regulation, it is imperative that the UK's interests are well represented during this process. The British Government should ensure that it is actively engaged in the relevant global initiatives, including the EU summits and committees which deal with financial affairs, so that it can shape the resulting legislation; and *in extremis*, it should use its veto powers. Recent lobbying by the Private Equity industry offers a positive template to follow: it has persuaded Sweden, which currently holds the EU presidency, to support Britain's concerns about proposed regulatory changes. In theory, Brussels is committed to providing quantified impact assessments of the costs and benefits of its legislation; yet the recent Private Equity Directive was long on words, but short on concrete figures. Such imprecision offers London the chance to engage in more evidence-based lobbying.

If, however, European Directives imposing stricter standards of regulation across all member states prove impossible to avoid, Britain's best means of encouraging international financial sector firms remain in London will be to ensure that the other elements of the City's appeal as a financial centre remain strong. This means maintaining an internationally competitive tax regime, investing in infrastructure such as high-speed internet connections, and continually adjusting visa requirements to ensure that London continues to provide firms with access to a pool of international talent.

It also means devising clear, coherent new financial regulations and implementing them swiftly; markets abhor nothing as much as uncertainty. Of course, decisions as important as those determining the future of Britain's financial sector cannot and should not be taken on the hoof; but the recent tug-of-war between the Treasury, the Bank of England and the FSA has done considerable damage to confidence, and to the UK's reputation. A further source of uncertainty is the divergence between the plans of the main parties. This political uncertainty is adding costs to the financial services sector and needs to be replaced by longer-term stability and clarity.

Contributors

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