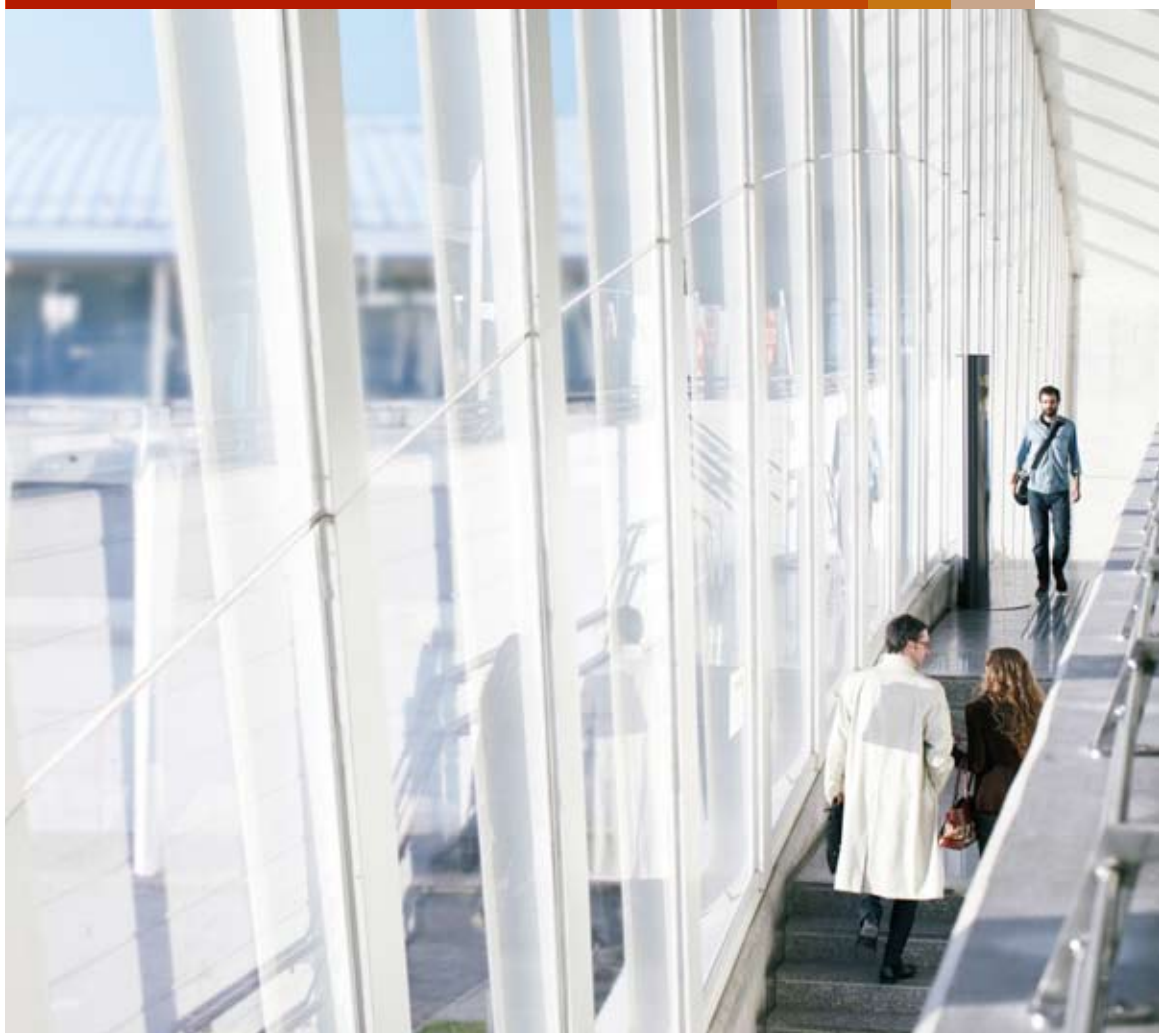


Too big to share

Balancing efficiency and self-sufficiency

October 2011

The Independent Commission on Banking proposals on ring-fencing are just one facet of global pressure to define orderly resolution plans. Against this shifting landscape, how can banks balance operational efficiency and self-sufficiency?



Overview

Demands of resolution will significantly shape future bank operations

Governments and regulators are developing a number of measures to reduce the impact on taxpayers of the collapse of financial institutions and to provide the foundations for orderly resolution of banks that do fail.

While the regulations are still being developed, a recurring theme is the need to remove barriers to resolution and demonstrate operational 'self-sufficiency'. This would require the bank to maintain services in or for a particular entity and to make sure those services are available even when other parts of the bank fail.

Even the failing entities within the bank will need to receive service if they are to be run down in an orderly way. Administrators will need access to applications and data, the ability to move and realise assets, value trades and conduct many of the same activities that were required in a going concern.

Pressure for self-sufficiency could undermine the shared service model

Self-sufficiency challenges the prevailing shared services model, in which support services have been rationalised and centralised across legal entities and business divisions. In some cases, these services will be provided by formally defined shared service centres, many of them offshore. Even where shared services have not been formally defined or located, banks will often share operational processes and technology across divisions and legal entities.

The main question for shared service operations is whether services can be maintained in a resolution scenario. Arrangements that work perfectly well in a going concern, in which all entities and divisions are part of the same bank with common goals, may break down in a resolution scenario. Resolution may result in one or more entities going into administration, being sold off or entering some form of special resolution or bridge-bank regime. In this case, each entity will be managed independently and the management or administrators of each entity cannot then necessarily rely on continued operational service being provided.



Why act now?

The legislative timetables of different countries vary, and global banks will need to develop a strategy before all the facts are clear.

Whilst initial legislative measures focus on creating transparency, the need to remove barriers to resolution can create the need for fundamental changes to the structure of a bank's operating model.

The potential changes are so far reaching that resolution considerations must become a key part of all Target Operating Model change, even where it is not the primary driver. If ignored, banks risk significant and expensive remediation work in the future and the possibility that pressure to deliver change quickly leads to a sub-optimal solution being rushed in.



What are the options?

In developing their models firms need to strike a pragmatic balance between the desires of the regulators and the need for commercially viable solutions (see figure 1).

The starting point is to understand how the bank delivers the key functional services, to who those services are delivered and what underlying infrastructure or external suppliers interact.

Figure 1

	High				Low
	Business Efficiency				
Financial	Parental Funding	Access to Liquidity	Enhanced Capital	Own Risk Management	No Parental Guarantees
People	No Employees	Secondees	Identified 'Flip' Employees	Critical Staff Employed	All Staff Employed
Services	Informal Agreement	Formal Service Levels	Step in Rights	JV Service Co	Own Staff and Own Contracts
IT	Informal Agreement	Formal Service and App Catalogue	Segregation of data/escrow	Segregation of Applications	Own Software and Hardware
	Low				Self Sufficiency
	High				

Gearing up for the operational shake-up

The driving force behind the need for structural change is the desire of governments and regulators to limit the burden on taxpayers and risks to the wider financial system if a bank fails.

A range of national and international legislative developments and consultations have resulted. The time table and specific demands of these vary, but all have a number of common elements:

- ringfencing or special measures designed to protect retail customers and small businesses and allow retail banking operations to be preserved in the event of a crisis,
- drawing up plans for how services could be continued in a situation where the bank or part of it failed, to ensure that an orderly resolution can be supported,
- measures designed to ensure the continuation of critical financial functions within national economies (e.g. Payments Services, Deposits),
- the ability to support an orderly wind-down of positions and pay out to clients and creditors, and
- the ability to continue or sell parts of the business (in particular to protect retail banking operations).

Assessing the operational impact

Most banks use shared services to a greater or lesser degree. This will vary from utilisation of staff or technology owned by one entity to process the transactions of others through to centralised 'one bank' shared services.

The problem is that in the event of a failure, legal entities in different jurisdictions may no longer be able or incentivised to continue delivering services to each other. Even within the same country the rules that are being introduced to ringfence certain functions and to separate Investment Banking from Retail Banking puts pressure on sharing of services.

The industry has recognised how the issue may impact upon the cross border operations of complex global banks. In the Institute of International Finance's (IIF) May 2011 Paper they highlight the requirement for a regime that allows banks to continue to operate in a sensible commercial manner.

Key developments driving self-sufficiency

G20: The G20-sponsored Financial Stability Board's consultative document, published in July 2011, sets out proposals on how to 'resolve systemically important financial institutions (SIFIs) without systemic disruption and without exposing the taxpayer to the risk of loss'

Swiss SIFI Policy: Under FINMA's 'Addressing Too Big to Fail', 'SIFIs are expected to prepare their organisational, operational and structural set-up so that their specific recovery and resolution plan can be executed rapidly and effectively'

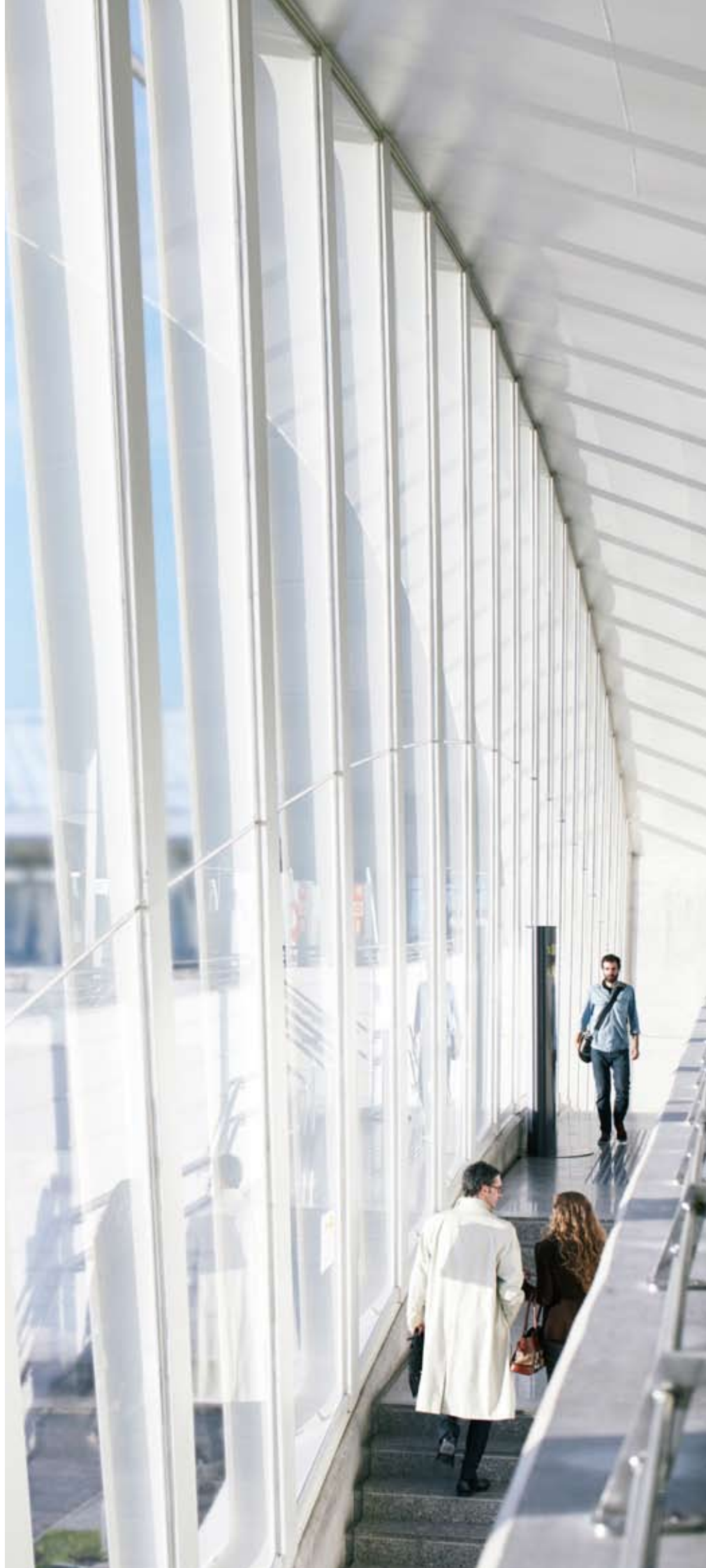
UK ringfencing: The Independent Commission on Banking (ICB) sets out proposals for 'ringfencing a bank's UK retail banking activities' to 'make it easier and less costly to sort out banks if they got into trouble, by allowing different parts of the bank to be treated in different ways'

US Dodd-Frank Act: The 'orderly liquidation authority' conferred by the Act requires banks to devise resolution plans detailing how they could be wound down should they become insolvent

“ ... that financial groups continue to be able to choose the mode of organisation and degree of integration of the management of their group that most conforms to the nature of their business model and the needs of their business. A forced requirement that: all firms, regardless of their business model, adopt a modular approach to their; organisation based on the stand-alone self-sufficiency of each legal entity or each; and national sub-group would dampen economic performance.”

IIF, Addressing Priority Issues in Cross-Border Resolution Paper,
May 2011

With numerous national and international bodies interacting with the industry (through its own various representative bodies) the final shape of the legislative landscape will take time to emerge. However regardless of the detail of the final regulations the core concept of resolvability and operational independence is a key factor in the future banking landscape.



The impact of self-sufficiency on the

The way in which complex banking groups currently provide shared operational services has any number of variations.

To simplify we consider 5 key models:

1. The Silo Model

Entity 1	Entity 2	Entity 3
Trading	Trading	Trading
Clearing & Settlement	Clearing & Settlement	Clearing & Settlement
Payments	Payments	Payments
Cash Management	Cash Management	Cash Management

- Each entity or division is self contained and owns and operates its own processes
- Flexibility is high within each entity
- Cost is higher as there is duplication (of function and change cost)

Description

Under the Silo Model, each of the bank's entities is self-sufficient with respect to the services it requires.

This has the disadvantage of increased cost as economies of scale are lost and changes required to a particular function must be implemented in multiple entities.

This model may be appropriate where each entity has a distinct set of requirements and limited commonality.

2. Informally Evolved

Entity 1	Entity 2	Entity 3
Trading	Trading	Trading
Clearing & Settlement	Clearing & Settlement	
Payments	Payments	
Cash Management		

- Some functions are shared potentially across more than one entity (e.g. some transactions processed in one region others in another)
- Most sizeable entities support smaller branches or subsidiaries
- Will tend to have evolved over time as business has grown, acquired and developed

Description

This model generally results from a bank that has grown both organically and through acquisition. Services are shared as the result of ad-hoc initiatives within specific functions or business lines.

Service sharing reasons vary and may include relative size or strength in a particular business and regional alignment.

3. Centre of Excellence (CoE)

Entity 1	Entity 2	Entity 3
Trading	Trading	Trading
Clearing & Settlement	Clearing & Settlement	Clearing & Settlement
Payments		
Cash Management		

- One business aligned entity is the centre of excellence for specific services and provides these services to the rest of the group
- Formal recognition of role increases the formality of the arrangements
- COE will generally have a specific distinction (e.g. handles highest volumes)

Description

This model tends to arise where one business unit has sufficient volume and expertise that they can formally provide services to the rest of the group.

An example seen in some groups is where payment services embedded within the retail bank are provided as a service to the other business lines (who potentially add a thin layer of functionality for the specifics of their own business).

service model

Impacts of self-sufficiency

The desire for self-sufficiency could be interpreted as requiring all services to be provided within each entity in geographic or business division led silos.

Where companies are already vertically aligned by entity (through reasons of geographic alignment or non-organic growth) there may be less perceived pressure for change posed by self-sufficiency.

The inherent cost inefficiency of the model is unlikely to be sustainable in a world where margins are reduced and capital more expensive

Impacts of self-sufficiency

Service models that have grown up and evolved over time tend to create an organisational structure with a variety of formal and informal arrangements. These models would pose the greatest challenge to resolution, as evidence from the crisis indicates:

- shared service units lost staff and capability without the role that they played supporting other entities being understood,

- confusion existed between individual entities as to ownership of applications, rights to use applications and obligations to support applications, and
- confusion and delay related to rights to obtain data.

Informally evolved models cannot survive the needs of resolution planning and ringfencing and will need to move to one of the other models. Considerations for the restructure would include:

- are processes genuinely shared and common,
- is a process sufficiently comparable between divisions to allow for standardisation and centralisation,
- is the process stable and repeatable or does it require frequent adjustment and interaction with the front office,
- does the service company 'own' its own technology or is it reliant on the systems and applications of another part of the group, and
- are there other third parties that may be users of the service – broadening the customer base?

Impacts of self-sufficiency

CoE structures occur where one client-facing entity or business division takes responsibility for providing services to the rest of the group. Usually these are relatively formal arrangements.

Resolution considerations include:

- are services managed through clear Service Level Agreements (SLAs)? While existing agreements are unlikely to survive a failure, they at least provide a clear understanding of what is provided and a basis to formulate new arrangements in a recovery scenario,
- on what basis are services charged and what would an "arms length" commercial arrangement look like? Regardless of the pricing

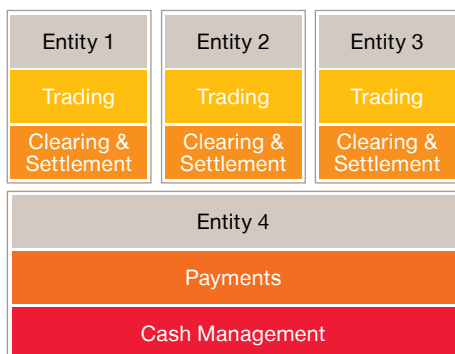
arrangements in a going concern, understanding the real cost of service may help management and administrators to establish new arrangements in a resolution scenario,

- are any services provided to other group firms that the CoE does not need for its own business, and would not be required to maintain in a resolution scenario,
- will there be regulatory barriers to overcome (data secrecy for example) if the entities are no longer part of a single group,
- if the CoE hosts a significant function will it need to be relocated to a different entity? Consideration will need to be given to whether the business unit that houses the CoE

itself has to be protected. For example if the CoE for payments services is in the retail banking division then it may be possible to retain the structure as both are inside the protected ring fence,

- formal intercompany arrangements, with contractually agreed service levels and charging arrangements will add a greater degree of commercial rigour to existing shared service models, and may provide a better foundation for a robust recovery plan, and
- utilisation of third party outsourcing. The use of 'step-in' rights for outsourcing purchasers may help assure continued service across all entities.

4. Service Centre



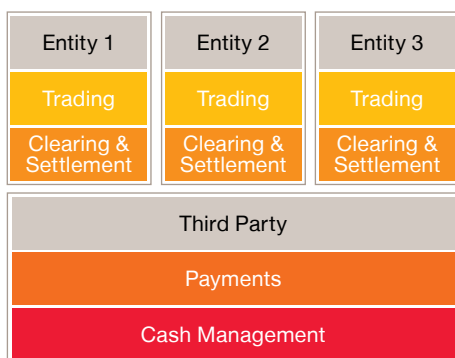
- Service company in a separate legal entity structure providing services to the other entities within the group
- Requires a formal contract/SLA as basis for service

Description

The service company differs from the centre of excellence in that the service centre is not embedded within a client facing business but provides an operational service to multiple different business entities from a separate legal entity.

Service company models are receiving a good deal of attention as being the “silver bullet” solution to self-sufficiency and sharing.

5. Outsourced



- Service is outsourced to a third party firm
- Requires a formal contract/SLA as basis for service

Description

In the Outsourced model, the shared service is provided by a third party outsource service provider.

Cost pressures on banks as they consider how to react to structuring concerns will drive many to consider outsourcing.

There is an opportunity for banks that have significant capability to consider providing services and for infrastructure providers to consider moving upstream.

Impacts of self-sufficiency

Service companies provide services across multiple divisions and entities. The legal entity that provides the services is independently governed and capitalised. As the service company is a separate entity, it can continue to provide services to different parts of the group as long as it has customers to fund it.

The clear separation offered by the service company model has been seen as a “silver bullet” solution to resolvability concerns. However, the bank failures that followed the financial crisis highlight further challenges in areas such as working capital requirements and funding. In some instances, service companies failed where staff could not be paid and had left before administrators were able to secure the services that their banks had relied upon.

Key questions to address include:

- how will the service company be funded in the event of failure? Are there enough different entities to continue paying for services if one of them fails? If the service company is reliant on one particular business line or entity for the bulk of their business then will it be able to sustain services for the other divisions if this primary source of revenue dried up?
- is there some other mechanism including new or emerging legislation that will assist in making the service company “bankruptcy remote”?
- is the service company sufficiently well funded to continue providing service for a period following a failure of a key group member?
- is the charging mechanism robust and commercially at arms length?

- are all services required, even in a failed bank scenario? For example services closely related to the trading business provided to the investment bank will not be required if the investment bank fails. How will the service company then react, will it immediately close down this service and shed jobs in order to protect the services that are required, or should such “business aligned” services be included in a service company in the first place?

Impacts of self-sufficiency

Shared services may be provided by third party outsource providers.

The formality of these arrangements is necessarily higher and so many of the concerns of inter-group arrangements are removed.

A number of considerations do exist:

- how robust is the outsource provider and would it survive the loss of a major revenue provider in the event of failure?
- are there conflicts if the outsource provider may be a creditor to a failed bank where the administrator requires services?
- in a complex group, which entity holds the contracts and do the other entities have “step-in rights”?

Given the costs associated with moving to resolvable structures we believe that outsourcing of key functions, in particular those significant functions that need to be ring fenced, will be a consideration for a number of banks.

This represents an opportunity to banks who have invested heavily in their service platforms and may consider commercialising these and providing services to other banks.

One other possible outcome is the creation of industry-wide solutions that would provide common provision of critical services. Infrastructure providers may be able to move their services further along the value chain, a move that may even be driven by combined industry pressure if the provider were mutually owned.



How should banks react?

Banks can see their resolution plans as a simple regulatory matter to be dealt with depending upon the timetable set out for the countries they operate in. In practice we believe that the medium and long term impacts of resolution planning and ring fencing measures are so profound that they need to be considered now. The wait and see approach is likely to be more costly in the long run and may place a bank at a significant competitive disadvantage.

Banks need to:

- Understand the relevant resolvability regulations and measures and the timetable
- Understand the key themes that are emerging and the implications of those themes to the structure of operational services
- Determine what can be treated as “given” assumptions around what services and structures will be acceptable
- Understand now how services are provided, what are the interdependencies and how will these be impacted in the future
- Review existing plans for changes to Operating Model (driven by efficiency or other reasons) and determine how the resolvability agenda impacts these
- Factor resolvability considerations into all future Operating Model thinking

Given the timetable for getting plans in place, the time for this action is now.

How can we help?

Resolution and ring fencing measures are one of a number of regulatory changes that will have far reaching consequences on bank strategy and operating models. The unprecedented wave of regulatory change provides an increasingly complex set of changes to consider.

PwC can help a bank to navigate this complexity as part of a wider sustainable strategy. We bring together deep skills in global operating model transformation, complex program delivery, regulatory advice and technical tax considerations as well as our unique insights gained as administrators of failed banks to help guide your strategy.



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