Prudential Regulatory Reporting – Seeing the competitive advantage over the regulatory burden

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The nature of the banking industry means that firms will always need to ensure they keep up with the evolving expectations of regulators. For some, regulatory compliance becomes an end in itself, a necessity to be invested in reluctantly. However, when delivered well, strong regulatory compliance can cease to be just a burden and instead be aligned with and support the creation of a strong, competitive business. Time and again we see that the strongest performing firms are those that see regulatory compliance as a foundation of their competitive advantage, rather than simply a box that needs to be ticked.

With its increasing number of regulations, high levels of regulatory change and a backdrop of market turbulence, prudential regulatory compliance is a key area where firms can position themselves to excel in a challenging market.

The primary driver for a strong and robust prudential regulatory framework, “the stick” for investing in prudential risk systems and infrastructure, is often the avoidance of supervisory actions, be they Skilled Person S166 reviews, Pillar 2 add-ons and/or fines. But firms also have the opportunity to grasp “the carrot”.

The questions for many may therefore be, what is the positive case for a strong and robust prudential framework, what does it look like when the framework supports a firm’s business needs and how can it provide a competitive advantage? Providing management with accurate, reliable and timely management information (MI) to make capital decisions, making sure the firm is maximising every capital advantage available, and ensuring that staff are not overburdened with remediation projects should be seen as significant upsides to support investing in a strong prudential function.

Below we explore in more detail the long-term benefits that firms can secure from having a strong prudential framework.

Prudential benefits

Accurate regulatory Pillar 1 metric calculations

Shortcomings in firms’ data or systems can result in them forgoing a capital or liquidity benefit or making conservative assumptions leading to punitive capital and liquidity requirements. In some cases, these are marginal, but they can be significant. As a firm’s strategy will always be to maximise capital efficiency within their business model and risk appetite, reducing the number of data defaults and conservative assumptions and judgements can be an avenue to improve a firm’s Common Equity Tier 1 (“CET1”)

capital ratio and Liquidity Coverage Ratio ("LCR") metrics without undertaking product or business change and, in doing so, allow more capital to be deployed to more business areas.

Accuracy becomes even more critical in an environment of regulatory change. With new capital requirements coming into play from Basel 3.1, firms should consider what new data points may be needed to ensure appropriate capital charges without defaulting to conservative workarounds. Likewise, proactive consideration of the implications of changes on the existing portfolio will allow management to make better decisions to optimise capital.

Reduced Pillar 2 add-ons

Where firms are not able to demonstrate a strong and robust framework with knowledgeable staff supporting the calculation of key prudential regulatory metrics, they are often required by the regulator to hold additional capital or liquidity through the SREP processes.

By being proactive in ensuring that strong and robust processes are in place, banks can ensure they have the most capital available to invest in the business to drive improved profits. Equally, timely remediation of issues will help to reduce Pillar 2 add-ons to for liquidity and capital.

Operational business benefits

Efficient regulatory systems, processes, infrastructure and calculations

Inefficient prudential risk systems and processes often result in a large volume of manual processes. These require additional full-time equivalent ("FTE") resources to "turn the handle" to produce minimum viable outputs such as Risk Weighted Assets ("RWA") outputs, Common Reporting Framework ("COREP") returns etc.

An overreliance on manual processes also increases the number of potential points of failure, the number of controls required to address these risks and, ultimately, the burden on management, for example through increased management review controls.

Investing in efficient automated processes not only reduces operational risk associated with manual processes, but also the demands on staff throughout the process. This permits the reallocation of resources from production-related regulatory requirement outputs to more value-adding activities such as forecasting and business decision-making or to revenue-generating activities.

Better informed business decisions

Senior management decisions will always depend on MI and will only be as accurate as the data that drives them. This is no different when considering capital allocation between business lines, products and divisions.

Any questions around the validity of the key metrics on which decisions are made brings uncertainty, therefore effective balance sheet optimisation and strategic decisions are predicated on complete and accurate data feeding key MI metrics.

An effective framework for ensuring the accuracy of data is paramount for an organisation looking to make good, timely decisions for its business, as well as ensuring that it meets the expectations of any

regulator.

Senior Manager / SMF capacity

It will come as no surprise that, when things go wrong, the time and costs associated with resolution are often exponentially more than the costs of preventing them before they happen. Whether firms are subject to skilled person reviews or have to run remediation projects, these exercises place significant time demands on key senior managers including SMF role holders.

Likewise, where BAU activities across the three lines of defence are not well designed, we often see an elevated burden on staff due to increased numbers of control deficiencies, exceptions and observations. By creating a robust control framework which minimises errors and clearly demonstrates ownership of key risks and mitigations, the amount of time required to investigate and remediate prudential regulatory matters is reduced. This enables key senior managers and SMF role holders to invest more of their time in value-adding areas of the business.

Firms will always have to respond and adjust to the evolving expectations of regulators, and even the most robust control environments will never prevent all risks from crystallising. Remediation projects and reacting to challenges as they arise will continue to be part of doing business for most banks and building societies. However, firms can reap significant rewards by investing in their prudential environments and seeing beyond “box-ticking” to the benefits of a strong and reliable framework in creating a profitable and effective business.

How can you build a prudential framework that generates these benefits?

Firms should consider how they can build a better prudential framework that is accurate, robust and efficient to support the delivery of their business needs. A prudential framework that is reliable and presents the least operational risk will ultimately be the best foundation for any business and ensure management has the tools to make good decisions. Investing to build such a framework will bring regulatory compliance and with it, a competitive advantage. Firms should consider the following as they move forward:

- The Basel 3.1 and the Small Domestic Deposit Takers (“SDDT”) regimes present opportunities to reset and ensure an effective internal infrastructure. The quantum of change requires significant enhancements to the prudential technology infrastructure and provides a chance to build systems and processes in a compliant and efficient manner to meet the firm’s business needs.

- Firms should ensure there is oversight of the decisions being taken in order to find opportunities for improvement and areas for change. This should include a repository of all the data defaults, interpretations and judgements made in calculating their capital and liquidity requirements. Identifying areas where business is not optimised will allow management to better address business needs.

- Critically, firms should consider their end-to-end process framework and understand the data lineage of the Key Data Elements (“KDEs”) used to produce key regulatory outputs. By compiling an internal data dictionary firms can begin to identify the gaps and remediate them. Furthermore,

better sight and understanding across the prudential and reporting infrastructure can enable firms to be more proactive and identify weaknesses before risks crystallise.

How can KPMG help?

The KPMG FS Risk and Regulatory Advisory team has extensive expertise and experience across all areas of prudential risk and we work closely with a wide range of banks and building societies. We can provide solutions to help you automate and de-risk you processes, helping to ensure that your frameworks are best designed to meet the needs of your business, find these competitive advantages and with it, help deliver regulatory compliance.

Contact us today to discuss your specific requirements and how we can help you achieve your goals. If you have found this post useful, please share with your colleagues.