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The big picture

Peter Serlachius, Partner at MORS Software, tells FX-MM why banks need to demonstrate a holistic, real-time knowledge of their business to satisfy regulators and retain their uniqueness.

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What are the biggest challenges facing banks today?

Banks are facing more and more directives and requirements and demand for metrics from regulators and other stakeholders by the day.

There are requirements from regulators around capital and loss absorbency, measured by capital requirements, by the leverage ratio, and this is also impacted by the recovery and resolution directive. Then there are requirements on liquidity and funding. On top of these are similar kinds of metrics, but not necessarily the same metrics, that banks use internally and there are other slightly different metrics required by ratings agencies.

When you pull all these metrics together, you quickly realise that different things move them in different directions. So if you focus on one metric and try and enhance or improve it, it will drag another one away from its optimum position.

Banks have always focused on profitability, but in the past a lot of that came from fee-based or advisory-based income that people might refer to as investment banking. Today, banks focus on long-term profitability as measured by net interest income, or net interest margin, which is the bread-and-butter business of making money from loans against deposits.

If that net interest income is stable and growing over time, everybody will be happy. The problem is, however, that the new regulatory constraints make it much more difficult to use the optimal balance sheet constituents to create that net interest income. That is because banks can't engage freely in maturity transformation in the way they did in the past because of these new considerations.

What are the dangers of not being able to show compliance with new regulation?

A new feature of regulation in Europe is the SREP framework, or Supervisory Review Evaluation Programme, which the European Central Bank manages within the concept of the single supervisory mechanism for the largest banks in the region, and that process cascades out via domestic financial supervisory authorities to the rest of the banks. Under that, banks have to understand the mechanics of their balance sheet, and forecast a lot of metrics and quotas. Banks have to demonstrate that they can show how they evolve over time and what drives them.

As part of the recovery and resolution directive, this SREP data is used to assess whether a bank is in a fit state, and failure to comply could lead to closure by the authorities. If banks happen to be in the wrong place at the wrong time due to weaknesses in their SREP data, and they cannot demonstrate that they have control over their balance sheet and that it can easily be repaired, then they could be closed down.

How can banks avoid that situation?

Banks are telling us they need the ability to measure all the different metrics intraday, in real time, so that they can look at all the different elements and see if they took one decision, what it would do to the balance sheet, earnings and all the different metrics, and see if it is something with which regulators and other stakeholders could live.

We are moving towards a world in which banks cannot manage different risk surfaces in different silos because all the elements interact with each other. They need to break the silos and place their most important data in one place. Then they can perform the type of simulations, scenario analysis and forecasting so they can understand their business and also please the regulators.

Is there a danger that all banks will start to look the same as they comply with the regulation?

In the eyes of the public, one bank looks very much like another, but if you look around Europe, large banks have a regional flavour and the differences are enormous. What is happening now is that we are moving from regional banking models to one universal model because these requirements are moulding banks into one shape. This "one size fits all" approach is not good from a financial stability point of view because banks risk ending up with similar types of balance sheets.

I think a lot of banks are recognising this and are trying to find ways to retain as much of their uniqueness as possible so they can stay in their banking market and service their clients. In order to do that, they need the tools to defend their position, so that they can demonstrate to regulators and ratings agencies what their management processes look like, how they manage the metrics and how they forecast those metrics.

I hope there is still room for diversity, but there will not be room for diversity if banks can't defend their position as being an outlier in some dimension. If banks can't make the proper arguments as to why they are operating as they are, it will be increasingly hard. For that, they need the right tools and to break down the silos within their organisations.

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