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NEW WORLD?
2017 GLOBAL
BANK REVIEW

Contents

Welcome

Welcome to the inaugural *Global Bank Review*. This is a publication by our Global Banks Sector Group, which brings together the people at Herbert Smith Freehills who live and breathe banks. The group's expertise spans the major financial centres of the world and includes practices across the firm.

It is trite to say that the banking industry is experiencing unprecedented change and, as such, "A Brave New World?" seemed an appropriate title to capture that sentiment. The sector is facing advancing technology, growing cyber security risk, increasing capital requirements and rising numbers of non-bank competitors. The regulatory landscape, its evolution, and in some cases revolution, has continued post the global financial crisis.

Our feature article on global financial regulation considers the financial regulatory trends we see emerging in the next 10 years and reflects on whether those trends are likely to be global or local. Regulation is extending its reach into broader areas and this is illustrated in the piece on climate change. We have also sought the views of some of our clients, to explore the role of the in-house teams at banks in meeting these regulatory challenges.

Continuing the theme of looking ahead, "The bank of 2040" incorporates perceptions from current bank leaders about the future state of banking, and looks at some of the trends and challenges facing the bank of the future.

The banking industry has always been ahead of the curve when it comes to the adoption of new technology. The rate of technological change and developments and the ever-increasing reach of the fintech industry is offering up new opportunities, as well as creating significant challenges. The articles "Forecasting five fintech developments", "Fintech: to regulate or to partner... that is the question" and "Padlocking the safe in a digital world" all touch on different aspects of this.

A review of the global state of play of the bank sector would not be complete without evaluating the conditions we believe to be holding back consolidation in the sector.

Why banks aren't chasing inorganic growth, as well as the key themes and drivers currently found in global leveraged finance, are also examined.

On behalf of the firm and the Global Banks Sector Group, we hope you enjoy reading the first edition of the *Global Bank Review* as much as we enjoyed writing it.

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The bank of 2040

The pace of change in global banking is unparalleled. Rapid advances in technology, combined with many other developments, will more likely mean that the bank of the future will look very different to the bank of today. In this article, the *Global Bank Review* peers into the crystal ball, with the help of some insights from current bank leaders, to see what those changes and challenges mean for the bank of 2040.

Technology

Undoubtedly one of the major challenges and opportunities facing banks globally has been the nature and pace of technological change. Technology has been at the forefront of the industry, having transformed the ability of banks to provide services where previously they were unable to do so.

Indeed, the impact of technology has been so extensive that it raises an interesting question: are banks indeed "banks" or are they technology companies?

The Chairman of the ANZ Banking Group Limited, David Gonski AC, told the *Global Bank Review* that while banks have banking as their core activity, "I believe banks are technology companies and I think they always have been. The essence of what banks have always done is that they have been an intermediary. And an intermediary, if you think about it, is technology."

There seems little doubt that banks will need to continue to address the technology question.

> Part of the core mission of banks over the next two decades will be to identify and apply productive technology.

Mr Gonski also told the *Global Bank Review* that, "The coming of artificial intelligence and indeed many of the IT-enabling functions will be greatly advantageous to banks. It will allow banks to provide a service more quickly."

It is safe to say that the bank of 2040 will have at its disposal new ways to connect with and serve its customers, and that those banks that can do that, as well as utilise the vast tracts of information made available to them, will be the ones that succeed.

Competitors

Related to the technology question is the emergence in the financial services sector of new entrants and services. These new entrants have thrown into stark relief the question of which companies will be the competitors of banks in 2040?

The breadth of participants in the financial services sector is wider, and is likely to continue to widen, over the coming decades. However, whether that will translate into the large technology companies like Apple and Facebook, or new start-ups, becoming true "banking" competitors remains to be seen. The reasons for a moment of pause are twofold.

First, jumping to the conclusion that these companies will become banking competitors ignores the threshold issue of the additional regulation that comes with a leap into the world of banking. Mr Gonski told the *Global Bank Review*:

"If I was sitting on the board of Alphabet which owns Google, or Facebook, the big decision I would have to make is: do I want to remain unregulated except perhaps in relation to anti-trust or whatever, or do I want to get into the regime of regulation? Regulation for banks involves equity levels which can reduce massively the returns of a publisher, a company like Google. My guess is that whilst regulation like I know it and like I expect it to continue and increase stays there, that there will always be a place for banks and they will not be competing in banking with the people like Google and Facebook."

Second, there are of course a wide and widening range of financial services that can be provided that do not involve banking. But the impact of new entrants in those areas needs to keep in mind the possibility if not likelihood that they will be subjected to an increased regulatory focus. That will have an impact on the ability of those companies as they seek to make an entrance into broader financial services or indeed banking activities.

It is also likely that traditional banks will seek to meet the challenge. The Chief Executive Officer of the Commonwealth Bank of Australia, Ian Narev, told the *Global Bank Review* that new entrants "will have a high degree of confidence in their ability to enter and compete successfully in new markets but they're not going to find unaware traditional competitors unwilling to compete."

The bank of 2040 is likely to see a wider range of competitors in some aspects of their business. But in traditional banking, it should not be assumed that the major banks of that time will be Apple, Amazon and Facebook.

Customers

Increasingly able to connect with their bank in new ways, the customer of 2040 will demand and likely receive an ever more sophisticated range of services that utilises their personal data, preferences and needs in a way that simply doesn't happen today. If banks get their use of data right, the results in terms of the customer experience could be transformational. Armed with the foundation of that information, the bank of 2040 will be able to provide services that will allow it to assert itself in fields of play well beyond a simple bank-customer relationship as we know it today.

The flipside of the customer equation is that the ability of customers to share their voice in relation to their experiences with banks will continue to increase. Technology enables the relationship, it will also keep it honest.

"If I was sitting on the board of Alphabet which owns Google, or Facebook, the big decision I would have to make is: do I want to get into the regime of regulation?"

DAVID GONSKI AC
CHAIRMAN OF THE
ANZ BANKING GROUP LIMITED

> In particular, we expect to see third party stakeholder concerns across a range of issues find a way into the regulation that banks will need to deal with day to day.
>
> **TONY DAMIAN**

An interesting part of the customer question, for those who have grown up with "the bank of 1980", is what will happen to branches? Branches will still be a relevant part of the service offering and network, though they will barely resemble the branches of years gone by. On the future of bank branches and their role over the next two decades, Mr Narev said:

> "We don't know what their role will be and so we need to experiment. And our current hypothesis is we will still need physical points of presence, they will just need to be used differently. They'll be used more for people who want to come in and chat, they'll be more consultative, they'll have more technology and they'll be less transactional."

Regulation

Since the global financial crisis, the pendulum of regulation has swung decisively and extensively in favour of greater regulation. It is likely that the pendulum has not reached all of its way, though as described earlier in the *Global Bank Review*, there have been moves towards some revisitation of regulation by the Trump administration in the US.

What will the regulatory landscape look like for the bank of 2040?

While there will be periods of divergence in global approach as domestic agendas in particular countries take precedence from time to time, given the increasingly global connectivity of the banking sector, we see the longer term trend involving more rather than less of a global approach to the key regulatory areas.

One area that we do see a difference in over the next two decades is the breadth of matters over which regulation extends. In particular, we expect to see third party stakeholder concerns across a range of issues find a way into the regulation that banks will need to deal with day to day. From climate change, to greater regulation around the use of finance proceeds (the demand chain, versus the supply chain) to enhanced disclosure regimes through to even more scrutiny on remuneration, the bank of 2040 will find itself regulated across greater fields of activity and concern than before. Some of that regulation may apply across business generally, but even in those areas, banks may prove a fertile testing ground for governments to apply new measures.

Technology will also be an area receiving increased regulatory attention over the next two decades. Facilitating the use of technology to improve retail customer outcomes, to create wealth and to help to manage risk, without reducing investor protections will be a focus. Regulators will also need to work hard to ensure that they keep up with the rapid changes across products and market structures. That will include managing the risks of technology based products and services provided by unregulated entities.

People and leaders

What does all of this mean for the people and leaders of the bank of 2040? There are a few things to call out on this front:

- First, there will be a continuing increase in the diversity, in terms of a whole range of factors, of the leadership of banks, as well as their workforces. Mr Narev told the *Global Bank Review* "If you do not have workforces and leaders that are representatives of the communities you exist to serve, you can't be successful."
- Second, among the skills required for bank leaders will be an understanding of technology as we continue to see rapid and far-reaching technology driven changes in the industry.
- Thirdly, leaders of banks will need to continue to have the skills and ability to manage the wide array of stakeholders, stakeholders whose views and voices will become louder and more demanding over the next two decades: As Mr Gonski observed, "Now, the CEO is more someone who has to bring together with a firm hand, but a conciliatory thinking, all sorts of stakeholders. Making profit is not the only thing you have to do."

In conclusion

It is a time of unprecedented change for banks. Technology, the competitors that might bring as well as the potential for a transformational customer experience, all suggest the bank of 2040 will have evolved from the present day into a very different looking enterprise. An intense regulatory focus will continue to be a backdrop against which those changes are set. And presiding over all of it will be the bank leaders of 2040, who will need to navigate all of these changes as well as increased stakeholder needs to successfully steer the course for the banks of the future.

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Banking on climate change

As countries around the world move to lower carbon economies and take steps to protect financial systems from "climate change" risk, there is a real prospect of regulatory action and private litigation against financial institutions that fail to prepare for and (if necessary) disclose the costs to their business of the move to this low carbon norm; and who take insufficient steps to mitigate against their direct and indirect exposure to damaging "climate events".

What are the "climate change" risks to the banking sector?

Financial institutions face three primary climate change risks:

Physical

The physical assets of financial institutions – and those of their clients – are exposed to the risk of damage or destruction by extreme weather and other climate events.

Transition

The value of the financial institution's investment in resource-based assets might significantly diminish in a lower carbon economy (for example, fossil fuel assets rapidly devalue as the global economy recalibrates to a low-carbon norm).

Disclosure

The risk that the financial institution does not adequately disclose its exposure to physical and transition risks, leading to regulatory investigations and shareholder claims.

Physical risks

Not only is the increased frequency of climate events a direct threat to asset value, a range of indirect costs can arise when assets are physically impacted by climate change, including increased insurance claims and portfolio losses, a decrease in investments' value, an increased risk of loan defaults and broader systemic shocks such as economic disruption and lower productivity.

The assessment of such physical risks by financial institutions is often done in isolation and not as part of a broader climate change assessment which could impact mitigation strategies.

A consequence of this risk could be that financial institutions seek to limit their losses by reducing their exposure and restricting lending and credit to companies and sectors with a high climate risk. The need to protect against physical risks is in part being recognised by the increasing number of financial institutions in recent years agreeing to implement the Equator Principles in relation to their investment decisions (discussed further on the next page).

Transition risks

There are costs for all sectors, including financial institutions, associated with the transition to a low carbon economy, including the impact on asset valuation, costs of implementing government policy changes, adoption of technological developments and changes to market sentiment that might influence how a financial institution markets itself or targets projects of clients.

A key risk is where financial institutions have investment exposure to resources directly impacted by a move to a low carbon economy – for example, fossil fuel could rapidly re-price with booked reserves becoming unrealisable at historical valuations.

This risk is compounded with the implementation of accords such as the Paris Agreement under which 196 countries have agreed to introduce policies to limit global warming to no more than 2°C above pre-industrial average temperatures.

Meeting this target alone could require a significant proportion of "proven" fossil fuel reserves currently sitting on corporate balance sheets to remain in the ground, implying marked devaluation (or, in extreme cases, the writing-off) of those assets as Paris commitments are implemented. This could have significant implications for the value of financial institutions' investments and the clients they support.

Financial institutions that are not prepared for transition risk may face the devaluation of their investment portfolios or their balance sheets as the value of any collateral taken decreases or a borrower's business model and risk profile changes following government and market response to climate change.

Disclosure risk

This risk arises where financial institutions that are subject to continuous or periodic disclosure obligations fail to disclose their financial exposure to the physical and transition risks.

For example, the UK's Financial Reporting Council has opened an examination into the adequacy of risk disclosures made in the annual reports of two oil and gas exploration companies listed on the London Stock Exchange. The investigations, which were prompted by complaints filed by public-interest bodies, focus on whether the two companies failed to inform the market about material economic costs associated with moving to a lower carbon environment in breach of their disclosure obligations under the UK Companies Act.

Similarly, the Securities and Exchange Commission is investigating whether ExxonMobil's annual reports present a true and fair view of its financial position, particularly:

- whether ExxonMobil's annual reports accurately convey the extent of the risk to its business from climate change (including regulatory and technological risks), and
- whether the balance sheet materially overstates the value of its proven oil reserves, which have not been adjusted despite a fall in oil commodity prices of around 60% since 2014. This is said to be in contrast to the revaluations of other oil and gas majors who have written billions of dollars off the stated value of reserves.

The Financial Stability Board, an international body that monitors and makes recommendations on the global financial system established after the 2009 G20 London summit, convened a task force on climate-related financial disclosures (TCFD).

The TCFD's objective is to promote voluntary, consistent, comparable, reliable and clear disclosures around climate-related financial risk. The central idea is raising climate risk disclosure standards such that market participants will understand climate change related risks more clearly as they will have access to better quality information. Such an understanding may also contribute to a smooth market transition to a lower carbon economy.

The Equator Principles

Ninety financial institutions in 37 countries took steps to integrate environmental considerations into their financial decision-making with the adoption of the Equator Principles. These principles form a risk management framework used to assess and manage environmental and social risk in large projects.

The Equator Principles are now considered the industry standard and are applied globally to all projects where total project capital costs exceed US$10 million. Equator Principle financial institutions commit not to provide financing to borrowers which will not or cannot comply with their environmental and social policies and procedures, and to require borrowers for projects with greenhouse gas emissions above a certain threshold to implement technically and financially feasible measures to reduce such emissions.

In addition to assisting with risk assessment and management, these and similar measures amplify the effectiveness of government climate change policies by accelerating capital reallocation and investment in lower-carbon technology and practices.

- On 8 August 2017, Environmental Justice Australia, on behalf of two shareholders, commenced Federal Court proceedings against a major listed Australian bank asserting that the bank failed to adequately disclose the financial impact of climate change risk in its 2016 Annual Report (in breach of its obligations to give "a true and fair view" of its financial position).
- This is the first case of its kind to test the requirement of climate change risk disclosures by listed entities in Australia.
- This case emphasises the importance of financial institutions assessing, and where necessary, disclosing their exposure to climate change risk – including as a result of their investment in companies impacted by a move to a lower carbon economy (such as investments in fossil fuel companies and projects with environmental or emissions impacts).

Outlook

Although financial institutions are increasingly aware of the need for steps to address climate risk, challenges remain.

A recent survey of prominent Australian companies, for example, noted that many financial institutions did not disclose exposure to climate risk or, where there was disclosure, the scale or type of risks disclosed were inconsistent with other companies operating in similar environments. Another study reviewed public disclosures of the 100 largest funds in Australia and found that 82% had disclosed little to no evidence that they were considering climate risk.

In coming years, all financial institutions around the globe will need to develop and/or review assessment and management of climate legal risk, including physical, transition and disclosure risk.

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Forecasting five fintech developments

From the financial hub of London to the crowded streets of Hong Kong, the word on every banker's lips is "fintech". Some claim that the "revolution" has just begun. Others would argue this is merely the latest buzzword for a long history of banks integrating technology solutions into their business. Either way, the pace of change is certainly new.

What is the "revolution" all about?

Some say fintech suggests a world where the banking model as we know it now will no longer exist. Although banks have adapted to emerging technologies in the past, things are different now – certain developments raise innovative and market-changing possibilities, five of which we explore in this article.

Some see these developments as favouring the conclusion that the "traditional" banking model will be displaced. In our view, the impact of fintech is much more nuanced. Fintech offers much more than a threat to the traditional banking model – it offers opportunities for banks to improve efficiency and reduce costs, and makes financial services more accessible to underutilised markets.

Why are things different this time and what areas should banks be tracking?

Blockchain

Blockchain is essentially an electronic database of continuously growing records, called blocks. Blockchain-based solutions offer an unprecedented opportunity to increase banks' efficiency, reduce costs and improve the customer experience. Its potential rests on its ability to cut out the intermediary, offering transparency and accuracy of transactions to all parties who are part of the blockchain.

The investment by banks (jointly) and the interest from regulators (whose participation in a blockchain would enable them to monitor risk and compliance activities) makes this *the* area to watch.

As an illustration, "smart contracts" or "smart bonds" built on the blockchain can automate the execution process and remove administrative and intermediating services pre-execution. Most blockchain solutions are currently in the "proof of concept" stage, but it won't be long before they are ready to be rolled out to the general public.

Integrating the banking experience

One of the best illustrations of how the consumer's banking experience is changing is WeChat. Whether buying movies or flight tickets, paying bills or chatting with friends, this app seamlessly integrates the consumer experience for its almost one billion users (mostly in China) with the consumer's (external) bank account.

> In this new world, the regulatory environment is likely to be used as a tool to drive innovation.

A particularly exciting function from a financial perspective is the app's ability to allow users to give "red packets" (sums of money) to each other. While essentially an intra-bank or inter-bank transaction, it replicates virtually the Chinese custom of giving red packets to friends and family during special occasions. As similar platforms develop and launch in other parts of the world (for example, Hong Kong-based TNG Wallet), banking services will become more accessible, and more a part of, consumers' daily lives – even if the bank providing the underlying bank account is not the "face" of the platform.

"Bots": the way of the future

We predict that artificial intelligence-based technologies (eg robo-advisors such as San Francisco-based Varo Money and Trim) will be at the heart of a movement to drive increased activity in banking services and financial markets, engagement with financial services and consumers' financial literacy.

The appeal of these technologies lies in the cost savings they achieve by operating without "bricks and mortar", which can then be passed onto consumers (for example by lower or zero fees on trades), together with the ability to virtually appear on consumers' mobile devices to suggest and enable trades and other investments.

> Consumers will have unprecedented access at their fingertips to what used to be traditional banking services.

Regulator collaboration on an unprecedented level

Technology enables the transmission of all kinds of data and services swiftly across geographical boundaries. Regulators recognise the extra-territorial reach of some of the services offered, entering into cooperation agreements relating to fintech collaboration with regulators from other jurisdictions (for example, the Monetary Authority of Singapore's cooperation agreements with regulators from Australia, France, Switzerland, the UK and Andhra Pradesh (the "fintech valley" of India), as well as the Association of Supervisors of Banks of the Americas).

It is unclear if these partnerships will make the regulatory landscape more coherent: in some respects, regulators are in competition to provide a robust but fintech-friendly regulatory environment. Judging from the various regulators' sandboxes (where fledgling fintech enterprises can test innovative products, services and delivery mechanisms in the real market, with real consumers), the race is on. In this new world, the regulatory environment is likely to be used as a tool to drive innovation.

Banks adopting "Regtech" solutions

Regtech, as distinct from fintech, focuses on developing technology-based solutions to manage regulatory risk and assist banks with regulatory compliance.

These solutions are increasingly common in the market, such as Trulioo (based in Canada) and Truster (an Irish start-up acquired by US-based TransUnion), which offer customer identification and fraud prevention services, and solutions focusing on recording and reporting. These solutions enable banks to tackle a wide range of compliance obligations in a more efficient and cost-effective way, such as KYC checks, trade or transaction reporting, or monitoring conversations between advisers and customers over social media messaging apps.

The forecast for fintech?

Regardless of what the future holds, one thing we know for sure is that consumers will have unprecedented access at their fingertips to what used to be traditional banking services. Banks which recognise and adapt to the changes in consumers´ expectations will be well-positioned to reap the rewards of the fintech revolution.

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Feature Article

Global financial regulation – the decade ahead

Central to the response of the international community to the global financial crisis of the early 2000s was a move to strengthen international regulatory standards and to improve cooperation and coordination amongst regulators. A question for the decade ahead is how much of that global approach will survive?

Consensus building

At a meeting held in London, in early April 2009, the leaders of the G20 nations, responding to "the greatest challenge to the world economy in modern times", agreed to implement what they described as a "global solution" for a "global crisis".

The G20 leaders agreed that major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. They resolved to take action to build a stronger, more globally consistent, supervisory and regulatory framework for the future financial sector. A new Financial Stability Board (FSB) with a strengthened mandate was established and the scope of regulation was widened; there were real efforts to improve cooperation and coordination.

Even as sovereign parliaments insisted that they would reach their own views on matters of policy, there was a general coalescing around what could fairly be described as global principles proclaimed by the G20 and elaborated upon by the FSB, the Basel Committee on Banking Supervision, International Organisation of Securities Commissions (IOSCO) and others. Banks tended to recognise the need for change but complained loudly about the burden and impact of that change.

From its inception, the FSB played a role in coordinating the development of regulatory, supervisory and other financial sector policies. As it describes itself, the FSB has all the main players who set financial stability policies across different sectors of the financial system at one table. "So when policies are agreed, they also have the authority to carry it out." In truth, it has sometimes seemed that the FSB´s regular report cards on the status of implementation of those agreed standards in particular jurisdictions have carried little weight.

Countries were ready with explanations and excuses and little cost or even opprobrium attached to a fail grade. Even where any two jurisdictions could be said to have implemented an international standard, there were often differences that arose in the local legislative process and which led the banks to complain of inconsistent implementation. Those differences could not always be smoothed over.

But for all those challenges, there is little doubt that there has been a real strengthening of regulation in areas such as capital and risk management and there have been real improvements in international regulatory cooperation, including information sharing, and cooperation around recovery and resolution.

United States

Has momentum stalled?

In the early days of his administration, President Trump issued a set of Core Principles for Regulating the United States Financial System (Principles) and declared it to be the policy of his administration to regulate in a manner consistent with those Principles.

Many of the Principles could be expected to receive bi-partisan support: for example, principles to empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; to prevent taxpayer-funded bailouts; to foster economic growth and vibrant financial markets to enable American companies to be competitive with foreign firms in domestic and foreign markets.

Other Principles, however, especially when considered alongside contemporaneous correspondence that issued from influential members of Congress and criticism of aspects of the Dodd-Frank legislation might suggest that the US intends pulling back from efforts to reach an international consensus on the content of regulation.

Would "America First" be inconsistent with the approach to regulation pursued with vigour since that 2009 G20 meeting in London?

There is nothing necessarily troubling about Principles to advance American interests in international financial regulatory negotiations and meetings, nor in the wish to restore public accountability within Federal financial regulatory agencies and there have long been calls to rationalise the Federal financial regulatory framework, but there are questions nonetheless about US commitment.

And it matters. A breakdown in regulatory consensus makes cross-border business more complex and expensive and increases operational risk. As a practical matter, in most areas of the financial markets if there is no US agreement, there is no meaningful regulatory consensus.

The real test of US intentions and a guide to the future would follow from the second part of President Trump's decree. The Secretary of the Treasury was directed to consult with the heads of the member agencies of the Financial Stability Oversight Council (including the Federal Reserve, SEC and CFTC) and to report to the President within 120 days on the extent to which existing laws, treaties, regulations, guidance, reporting and record-keeping requirements, and other Government policies promote the Principles and what actions have been taken, and are being taken, to promote and support the Principles.

In June 2017, the Treasury duly reported and identified what it described as significant areas for reform in order to conform to the Core Principles. The review identified a wide range of changes that it said could meaningfully simplify and reduce regulatory costs and burdens, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public.

The Treasury report runs to nearly 150 pages and again, many of the proposals will surely enjoy bi-partisan support but what stands out is how inward looking that report is. There is remarkably little regard paid to international fora nor to the importance of international consensus. Where reference is made to international standards, it is often to recommend a pause in implementation to better assess the appropriateness of that standard for the US domestic market. Even allowing for the historic distinction made by US regulators leading to the non-application of Basel standards to some US domestic banks, there seems to be a real change in attitude to the international order. For example, Treasury recommends delaying the domestic implementation of the Basel Net Stable Funding Ratio and Fundamental Review of the Trading Book rules until they can be appropriately calibrated and assessed. It is said that "both of these standards represent additional regulatory burden and would introduce potentially unnecessary capital and liquidity requirements on top of existing capital and liquidity requirements. US regulators, it is said, should also rationalise and improve the risk-based capital regime over time through, for example, reducing redundant calculation approaches and improving risk sensitivity in the measurement of derivative and securities lending exposures". Of course, the US authorities were leading participants in the Basel discussions that led to agreement on all those international standards. Going forward, one may ask, will the US continue to participate in the international fora in the same way as an opinion leader in efforts to shape international consensus? Or will they operate on the basis that convincing others to accept their view may be desirable but no longer regarded as important? Anecdotally, regulators from other jurisdictions have noticed a change in approach by US regulators to the discussions in those key international fora.

The US Treasury report recommends increased transparency and accountability in international financial regulatory standard-setting bodies and improved US inter-agency coordination before concluding that international regulatory standards should only be implemented in the US through consideration of their alignment with domestic objectives and should be carefully and appropriately tailored to meet the needs of the US financial services industry and the American people. At one level, one might say that is a very sensible, indeed responsible approach but it does seem to foreshadow a significant change in attitude.

For example, Treasury recommends additional study of the recalibration of standards for capital and liquidity that have been imposed on US globally systemically important banks. These regulations are said to add significant complexity to capital and liquidity requirements and there is concern they may have adverse economic consequences that can be addressed without impacting safety and soundness. In other words, the US is walking away from the consensus, built up over several years and commencing with that G20 meeting in April 2009 on how to ensure the effective and consistent prudential oversight of the world's largest internationally active banks.

The US Treasury does "generally" support efforts to finalise remaining elements of the international reforms at the Basel Committee, including establishing a global risk-based capital floor, because it believes banks in other jurisdictions receive more favourable treatment than US banks and "in order to promote a more level playing field for US firms and to strengthen the capital adequacy of global banks, especially non-US institutions that, in

some cases, have significantly lower capital requirements". Regulators in other jurisdictions will, of course, dispute the premise of Treasury's "general" support: support for international standards because you believe that they are bringing others up to the standards required domestically is qualified support, at best.

There is, however, some good news for those who believe in the importance of international regulatory consensus. In its report, Treasury considers foreign investment in the US banking system to be an aid to diversifying the risk of the financial system and propelling economic growth. It is recommended, therefore that regulatory standards on living wills and liquidity, should be recalibrated and greater emphasis should be given to the degree to which home country regulations are comparable to the regulations applied to US bank holding companies. That is a change for the better when compared against the previous policies of the US FDIC and shows that a willingness to recognise and rely upon regulation in other jurisdictions remains part of the US approach, at least where there is a discernible US interest.

Other regulators do not necessarily follow where the US leads but, one may ask, in the absence of strong US support for international standard setting, should we expect the drive for global consistency to fall away?

Europe

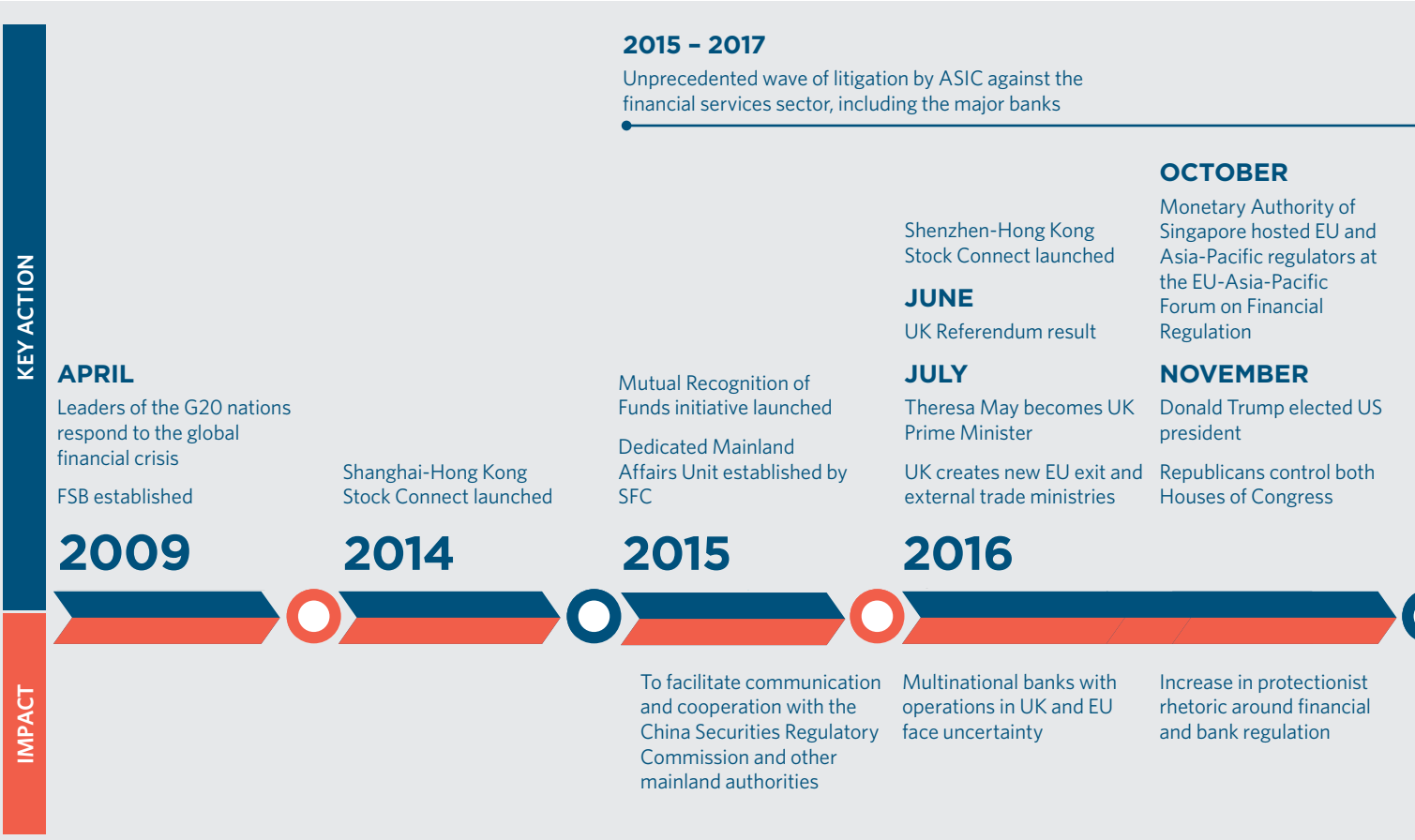
Europe at the crossroads

As already observed, there have been examples in recent years of the EU departing from or going beyond international consensus in agreeing post-crisis regulation. There have also been cases where the EU appeared to operate on the mistaken assumption that if it implemented an international standard in a particular way, the US and others would follow. More recently, there is an example of the EU appearing to follow the US (some would say in reprisal) in proposing that large foreign banks operating in the EU should establish a EU domiciled holding company to sit on top of those operations. Whatever regulatory arguments there may be in favour of such a measure, the proposal is likely to increase the cost of funding for affected banks and result in further regulatory fragmentation.

Within the EU there remains an apparent resolve to continue to strengthen the single market and there does not appear to be any wavering of commitment to institutional structures such as the Single Supervisory Mechanism allowing the European Central Bank (ECB) to oversee the supervision of the largest Eurozone banks.

What impact might Brexit have on international consensus?

For the UK, the immediate effect may be a strengthening of its position at the major standard setting bodies. Generally, the UK already has a seat of its own, for example at the FSB and in Basel at IOSCO but after it leaves the EU, it will no longer have any need to maintain a position consistent with that of the EU. Of course, that may lead to further fragmentation of regulation.



The UK, even as a member of the EU has gone its own way in several important areas including the introduction of ring-fencing legislation, a tougher approach to bank bonuses and the introduction of the senior manager regime to strengthen individual accountability.

In the second half of 2017, the outcome of Brexit negotiations for the withdrawal of the UK from the EU at a political level remains unclear, as just one element of the broader global geopolitical, macro-economic, and environmental uncertainty which prevails in early decades of the 21st century. What is certain, however, is that the EU's financial authorities are making preparations for what some commentators predict to be a mass exodus and what others predict to be just a repositioning of international financial firms from London to the continent.

At the end of May 2017, the European Securities and Markets Authority (ESMA) was the first of the three European Supervisory Authorities (ESAs) to issue principles to guide competent authorities in the remaining EU member states when facilitating relocations into their territories from the UK. In particular, the ESMA principles aim at strictly discouraging the establishment of so-called "letter-box" entities, that is, legal entities which give the firm access to the single market, while retaining substantive activity in London. In July, ESMA provided further more detailed guidance applicable for specific sectors of investment business. The European Insurance and Occupational Pensions Authority and the ECB, as supervisor for the Banking Union, have also issued relocation guidance and materials.

Such principles and guidance, as much as providing an insight into regulatory expectations for firms considering their response to Brexit, also speak to how EU level institutions might attempt to manage competition between Member States for the crown jewels of the financial world which London is expected to cede. Arguably, the principles must also apply to any non-EU, non-UK financial businesses seeking to access the single market. Politically, at least, the ESAs must avoid being seen to penalise the UK more than other non-EU countries.

It will be open to the UK to seek to negotiate a unique relationship with the EU governing financial services. For example, a treaty arrangement might be sought, which sits above the existing complexity of third-country relationships with the EU, governed as they are in a variety of ways by individual directives and regulations. The majority of commentators expect that in the early years post-Brexit the UK will remain close to the EU in the content of its regulation, partly because of the sheer volume of that regulation and the time it will take to review it and partly to enjoy such benefits as may arise from an EU assessment of "equivalence" in a particular area. But the existing equivalence landscape is fragmentary and not a sufficient basis for most banking models to operate out of the UK into the EU. Moreover, there is every reason to expect that on important matters of regulatory policy, the UK Parliament and UK regulators will eventually want to express their own views: divergence from the EU is inevitable over time. Perhaps, on a particular topic, the UK will move closer to the US than the EU, perhaps not. A "third way" seems distinctly possible.

Bond Connect launched

JANUARY

US presidential inauguration

UK Supreme Court requires government to seek parliamentary authority to serve Article 50

MARCH

Article 50 Notice served

MAY

ESMA was the first of the three ESAs to issue principles to guide authorities in remaining EU member states when facilitating relocations into their territories from the UKJUNE

Consultation between Secretary of the Treasury and heads of the member agencies of the Financial Stability Oversight Council

Report released regarding existing laws, treaties, regulations, guidance, reporting and record-keeping requirements and other government policies

Reform recommended

JULY

China's National Financial Work Conference

OCTOBER

China National Congress

END OCTOBER (OR LATER)

UK and EU to agree terms of leaving and implementation

MARCH

UK to leave EU

2017 **2018** **2019**

Increase in protectionist rhetoric around financial and bank regulation

Announced that the mainland will set up a committee under the State Council to oversee financial stability and development.

Asia-Pacific

Asia-Pacific: champions of the international consensus?

What of Asia-Pacific? Generalisations about such a diverse region are inevitably open to exceptions but there are some discernible features of recent years that may be expected to continue into the future.

Although the European jurisdictions have a greater voice at many of the international standard setting bodies, the jurisdictions of Asia-Pacific have shown a willingness to implement those standards, and a willingness to enhance cooperation and information sharing within the region and beyond. The Asia-Pacific regulators have, for example, started to meet as regional regulatory colleagues to share information and coordinate the supervision of individual entities. Those same regulators and their legislatures have by-and-large shown a willingness to implement international standards in a manner that allows for both a positive equivalence assessment by the EU and a decision by US authorities to allow "substituted compliance": not always straightforward given EU/ US divergence! We should expect that to continue even as it becomes more difficult to meet diverging standards.

In October 2016, the Monetary Authority of Singapore hosted regulators from the EU and the Asia-Pacific region at the inaugural EU-Asia-Pacific Forum on Financial Regulation. The focus was on information sharing, the current and future regulatory framework governing financial services at an EU level and in the jurisdictions of the Asia-Pacific region, challenges in cross-border coordination and emerging policy priorities.

Similarly, market regulators, meeting as the Asia-Pacific Regional Committee of IOSCO are working toward the implementation of a regional road map. That work includes strengthening working relationships with other regional bodies such as the FSB Regional Consultative Group for Asia, the Association of Southeast Asian Nations and the Asian Development Bank. There are also existing regional initiatives, such as the Capital Market Takeovers Forum and the Regional Regulators Group on Market Surveillance. The IOSCO grouping has expressed a commitment to implementing consistent and effective regulation benchmarked against sufficiently granular international standards - although one might observe: if there are any.

Certainly the commitment to greater collaboration in the supervision of cross-border financial institutions, and strengthened financial regulatory cooperation in Asia Pacific appears strong amongst regional regulators. There is also work being done on developing mutual passporting and recognition arrangements in the region. IOSCO has also said it will look to map key areas of the regulatory framework to identify areas for capacity building, possible mutual recognition and cross-border opportunities.

In the view of some economists, by 2027 China will be close to overtaking the US to become the world's largest economy so let us end this discussion with some observations about how China may approach global regulation.

China held its National Financial Work Conference in July 2017. According to Xinhuanet, President Xi Jinping announced at the conference that the mainland will set up a committee under the State Council to oversee financial stability and development.

The People's Bank of China will play a stronger role in macro prudential management and guard against systemic risks. China will, "at a steady pace", further open up its financial market to promote the internationalisation of the Chinese yuan and capital account convertibility.

The interconnectivity of the mainland and Hong Kong markets has increased rapidly in the last few years, resulting in the need for regulators in both markets to enhance regulatory cooperation. Contributors to such interconnectivity include the Shanghai-Hong Kong Stock Connect launched in 2014, the Mutual Recognition of Funds initiative in 2015, the Shenzhen-Hong Kong Stock Connect in 2016 and the Bond Connect earlier this year. In addition, mainland institutions are playing an increasing role in the Hong Kong market. According to the Hong Kong Securities and Futures Commission (SFC), about 13% of Hong Kong licensed corporations are controlled by mainland corporates. Mainland firms currently account for around 70% of sponsor business, 10% of securities dealing and 40% of margin loans in Hong Kong. In view of the increased connectivity with the mainland, the SFC established a dedicated Mainland Affairs Unit in 2015 to facilitate communication and cooperation with the China Securities Regulatory Commission and other mainland authorities.

China is a member of the FSB, the Basel Committee on Banking Supervision and the Board of IOSCO. Four Chinese banks are among the 30 banks identified by the FSB as the globally systemically important banks. The FSB assesses China to be ahead of the EU, and arguably ahead of the US, in its implementation of the Basel 3 capital reforms. If the US Treasury recommendations discussed earlier are implemented, the US may well fall further behind China in its FSB rating.

What does this changing regulatory environment mean for global banks?

We have then a situation in which the Asia-Pacific region, including the rising giant of China, is showing a strong commitment to international standards and consensus just as the US arguably moves away from its global leadership role. The EU remains apparently constant in its commitment but for how long if the US shows signs of withdrawal? The UK is poised to jump but in what direction, is unclear: perhaps, increasingly to take its own path.

All that suggests increased complexity and cost for internationally active banks. Those banks already struggle with the challenge of implementing new regulation. That challenge is likely to get more difficult in the years ahead.

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Australia

Australia: regulation by litigation

The past two years have seen an unprecedented wave of litigation by the Australian Securities and Investments Commission (ASIC) against the financial services sector, including the major banks. Banks are also being served with an avalanche of notices to produce documents and answer long lists of detailed questions. Even when an investigation does not warrant court proceedings, ASIC is increasingly insisting on "enforceable undertakings" with a substantial "community benefit" payment as the price of peace. Where a particular issue affects more than one bank, ASIC is adopting a divide and conquer strategy – obtaining a concession from one bank and then pressuring the others to do the same.

ASIC has received substantial funding to investigate and prosecute the banks. It may well be that ASIC, in turn, feels it should to deliver a return on that investment.

What is missing from the political debate and, it seems, from ASIC's strategy, is an accounting of the cost of the strategy of regulation by litigation. Hundreds of millions of dollars have been spent by ASIC (at the expense of taxpayers) and the banks (at the expense of customers and shareholders) dealing with enforcement. And the cost is not just financial. When ASIC and senior management of the banks spend significant amounts of time raking over the coals of the past, they are left with less time to focus on improving customer outcomes in the present and future.

To be clear, ASIC enforcement activity has an important role to play in regulating financial markets. If misconduct is not punished, it is encouraged. However, ASIC's track record of identifying institutional, as opposed to individual, misconduct in the financial services industry is patchy at best.

More significantly, much of the litigation commenced by ASIC does not truly concern misconduct but arises from genuinely held but differing interpretations of the relevant law. After one of its most significant court losses, against Citigroup in 2007, ASIC said that where it "feels that clarification of the law by a court is important, it will as a matter of policy, commence proceedings".

It is difficult to consider that litigation is the most efficient and effective way to clarify the law. If ASIC was prepared to reserve investigations and litigation for cases of suspected misconduct and to engage in dialogue with the banks as a whole about industry issues and legal uncertainty, customer outcomes for the future would be improved more quickly and cost-effectively.

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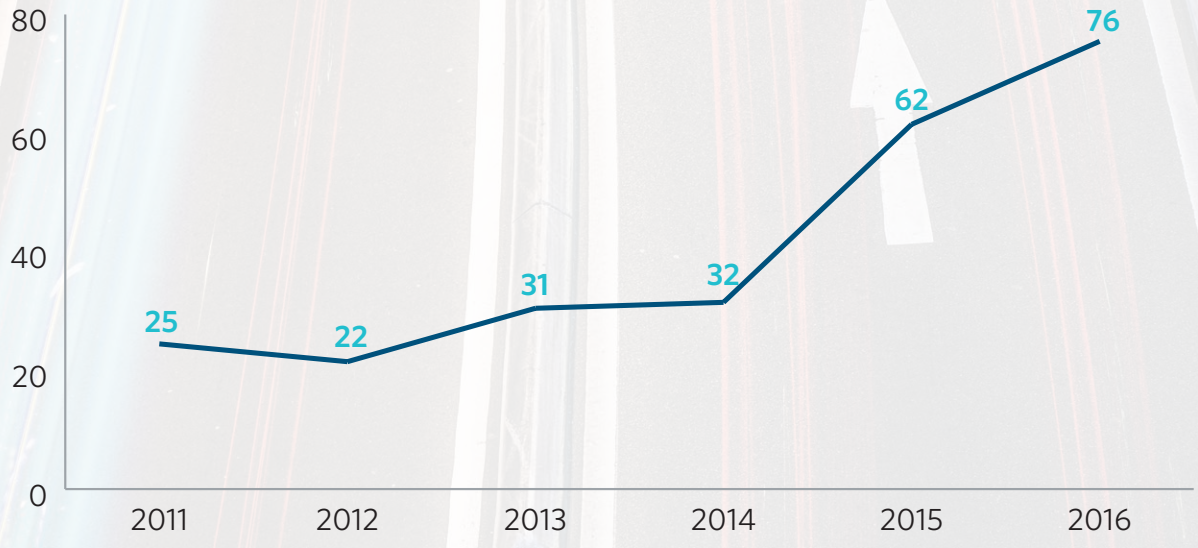
ASIC – Pending court proceedings (financial services)



(Not) chasing inorganic growth

It seems that we still await the long-expected surge in global bank M&A. Given that structural market conditions are so favourable for M&A, it is time to consider what forces are holding back the tide and delaying consolidation activity, and whether we will see a change in conditions any time soon.

The global financial crisis created a new playing field, forcing a significant amount of consolidation between domestic competitors and leaving numerous casualties. Many of the leading international banks have repositioned strategically, some slimming down investment banking activities and transferring strategic focus to asset and wealth management.

So there has been more selling than buying as banks have divested assets, most commonly to non-bank financial services players. Some divestments have been in response to regulatory requirements having benefited from state aid during the crisis, or as they seek to refocus on core operations. These have included Deutsche Bank selling its Abbey Life business to Phoenix and National Australia Bank selling its life insurance business to Nippon Life Insurance Company.

In the abstract, there are two types of M&A activity which should logically be strong:

- Acquiring "disruptors" to seek to mitigate and benefit from the disruption which will inevitably have a major impact on the banking sector.
- Consolidation between banks to benefit from economies of scale and better serve the increasingly global corporate market.

  We currently have a fragmented market, with a large number of local, regional and national operations competing within their markets against each other and against the handful of truly international operations.

  Consider this: in May 2017 there were almost 5,000 banks within the European Union alone. Smaller national and sub-national operations face significant challenges in meeting enhanced regulations and investing sufficiently in technology to keep apace with technological developments and the growing cyber threat.

  For many of these institutions, being part of a larger banking group able to leverage synergies and the benefits of scale would make strategic sense. From an acquirer's perspective the fragmented market provides a plethora of acquisition opportunities and the chance to grow scale reasonably quickly.

  The relative paucity of truly global retail banking brands means there is an opportunity for banks with the resources and brand strength to internationalise.

And yet despite a landscape highly suggestive of M&A, few deals of any size have occurred outside the US since the intense activity instigated by the global financial crisis abated. The reasons for this include:

- increased regulator focus on prudential and capital requirements, limiting the availability of capital to fund acquisitions,
- closer regulatory scrutiny of acquisitions and focus on the impact of acquisitions on the acquirer's financial soundness,
- concern at board level about:
  - legacy conduct risk and the potential to inherit very significant liabilities or adverse reputational impacts that may not be identified in due diligence,

- the cost, challenges and risks of integrating banks, particularly the cost of technological integration, and
- price expectation gaps: how do you value an under-scale bank in light of the disruptive effect of fintech and its threat to traditional banking models, making growth through M&A of existing traditional banks less attractive.

Acquisitions of disruptors bring their own challenges. For conservative boards and their shareholders, the idea of placing a significant "bet" on a particular substantial disruptor may be unappealing and inconsistent with their image of what banks do. Many banks are making small "bets" in this space – but they need one or more of those to be the one in thousands that succeeds to hope to move the dial.

And there can be a dis-synergistic irony where a bank acquires a disruptor. The nimble, management-light model of a fintech company which brings it success may be anathema or impractical for a bank, which will typically need to overlay is compliance, prudential and governance model to the business post-acquisition. While this is partly cultural the regulatory frameworks do banks no favours in this space, typically imposing far less regulation on the fintechs than on the banks with which they compete and which they seek to disrupt.

However, it's not all doom and gloom for bank M&A. The good news is that several of these issues could well be less acute going forward. After years of rising regulatory fines which have cost the industry over US$320 billion since 2009, global regulatory fines are now running at approximately half the level they were in their 2013-14 peak. It is too early to conclude that the tide has turned – and indeed the recently announced charges brought by the UK's Serious Fraud Office against several former Barclays executives is a stark reminder that regulators remain focused on enforcement activity. Yet there is clearly some scope for optimism for banks that the worst of the regulatory penalties are behind them. Banks are also generally better capitalised than at any point in modern history, providing a more robust and sustainable platform for inorganic growth.

In the fintech space, there are early signs that regulators and governments are becoming more sympathetic to the lack of a level playing field for the banks. Through structures such as non-operating holding companies and differentiated branding, it may be possible for banks to diversify through acquisition in a way which does not subject the acquired disruptor to the full burden of the bank's regulatory obligations.

If there is a silver lining in the various enforcement activity against banks, it is that a body of understanding now exists on what has tended to go wrong, and why. Focused due diligence which hones in on those risk areas, and integration programs to avoid legacy sub-cultures existing post-acquisition can significantly mitigate the risk of legacy issues which are later attributed to the acquirer.

The prize is huge for the banks which get this right. If one or two banks have the confidence and ambition to seek inorganic growth, and in particular if global banking regulators can be persuaded of the benefits of (appropriately capitalised) diversification and scale in and from the banking sector, they may establish themselves as the leading, truly global, banks in the world. On the flipside, the overhang of pending disruption is a defensive need to achieve scale and innovation, perhaps most realistically through acquisition. Those factors suggest that the long-awaited surge in bank M&A may become a reality after all.

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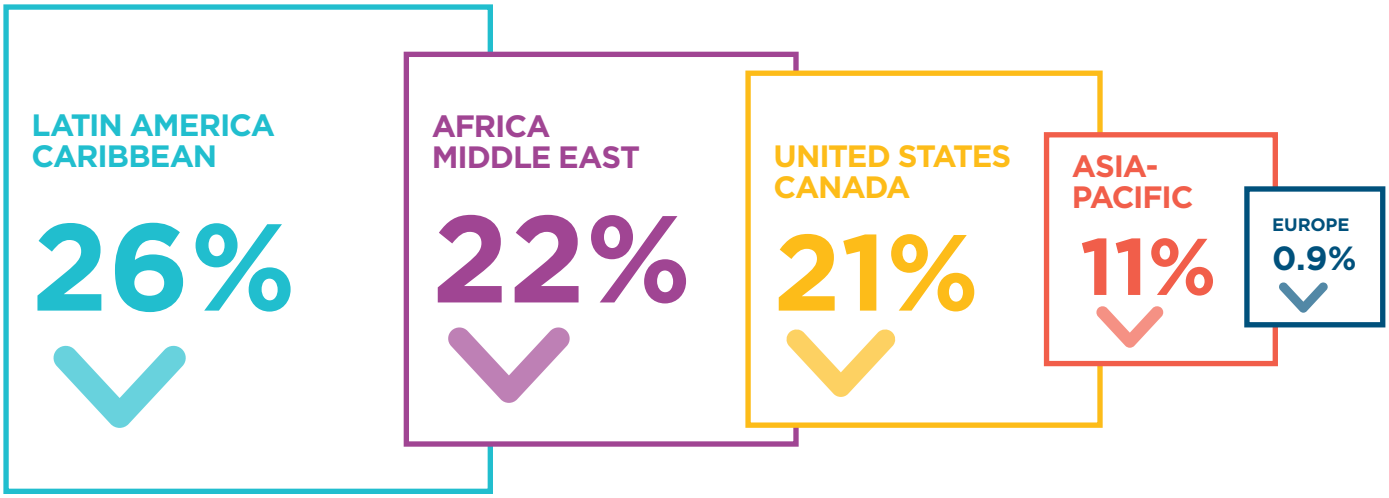
M&A IN THE BANKING SECTOR DECLINING, BY DEAL COUNT: 2015 VS 2016



Banks, Brexit and what's next?

The global financial crisis in 2008 and the slump that followed were predicted to change the face of international banking, mark a retreat from globalism and result in much tighter regulation of institutions.

The last is undoubtedly true, particularly in the European Union, as this region still struggles to deal with an overhang of bad debt and ailing banks. Overall, however, the reality is that international financial activity, fuelled by technological advances, trade movements and the flows of capital produced by "quantitative easing" policies of central banks, has continued apace as the US economy has recovered and Asian banks have taken more international positions.

Will this change in the foreseeable future? What are the key drivers and, in particular, how will the UK's decision to leave the EU – Brexit – affect the sector both in the UK, the rest of Europe and elsewhere?

As the EU's avalanche of banking regulation continues a pace and the US talks about dismantling parts of Dodd-Frank, we question whether the overall impact will strengthen the EU's financial centres or result in more banking activity elsewhere.

The UK outlook

Brexit is already having a strong impact on banks and financial institutions which have made London their European headquarters for dealing with customers and in markets throughout the EU, taking advantage of their EU "passport" to trade throughout the EU.

In the event that the UK leaves the EU single market without a deal to continue passporting arrangements (whether on a transitional basis or permanently), banks relying on their UK bases to trade in the rest of the EU will lose their passports and even banks which have businesses regulated elsewhere in the EU will find they cannot continue to carry out certain lines of business from the UK.

Given that the UK started its two-year notice period to leave the EU at the end of March 2017 and that EU regulators will struggle to deal with the expected number of simultaneous requests for authorisation, banks are beginning to announce their intentions: for example, Bank of America plans to obtain authorisation in Ireland, HSBC expects to move some of its business to its existing substantial French subsidiary and Deutsche Bank may repatriate to Frankfurt significant parts of the business it now does in London. Several US banks, while maintaining European headquarters in London, are planning to move some activities to other centres in Europe, for example, JP Morgan is reported as intending to move jobs to Dublin, Frankfurt and Luxembourg.

Altogether it is estimated that some 9,000 jobs may move out of the UK, although London is expected to continue as a major international financial centre and continue as the EMEA regional headquarters for many international banks.

> What will actually happen to some extent depends on what the UK and the EU may agree is the nature of any transitional period and subsequent long-term relationship.

The approach of the City is "plan for the worst and hope for the best".

The EU outlook

Although now showing signs of economic growth, the EU banking industry continues to be in a position of comparative financial weakness: as at December 2016, the EU on average had a rate of non-performing loans of 5.1% compared with about 1.5% for the US and Japan.

Its weakest group of countries on this measure includes one of the Eurozone's major economies, Italy: this led to the bailout in December 2016 of the significant and venerable bank, Monte Dei Paschi di Siena (founded in 1472 and the world's oldest surviving bank), followed in June 2017 by the takeover of two failing regional banks serving Venice and the surrounding area by leading lender, Intesa Sanpaolo, with support from the Italian State.

This experience, plus the difficulties for the Eurozone of operating the euro as a common currency without fiscal union, leads to a detailed and prescriptive regulatory regime for banks in the EU, with elements of protectionism against third country institutions (which can only benefit from the EU passporting regime by establishing subsidiaries which are regulated within the EU). Brexit, however, means that the EU loses its largest and only truly global financial centre.

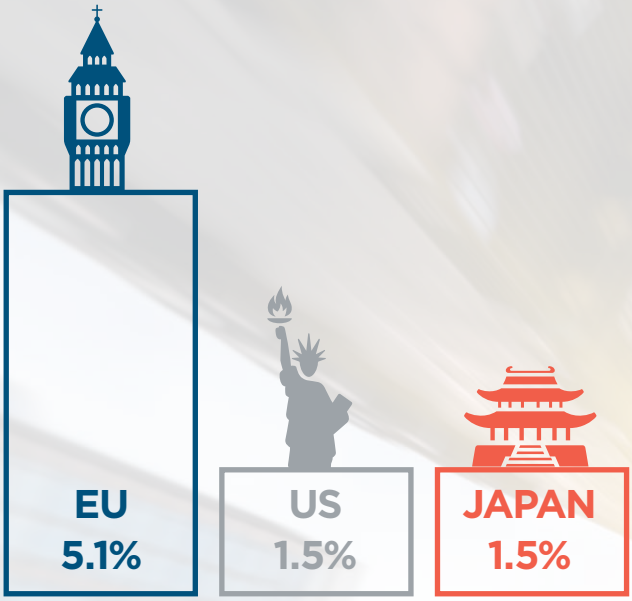
In June 2017, the European Commission proposed new rules for enhanced supervision of any clearing house dealing with systemically-important volumes of euro-denominated trade and, in certain circumstances, a right to ensure that this activity takes place within the Eurozone. The London Clearing House, which is part of the London Stock Exchange, estimates that it clears €927 billion in euro-denominated contracts per day, some three-quarters of the global market, other parts of which are situated in the US and Far East as well as within the Eurozone. All of these may face enhanced supervision.

While this legislation potentially carries more risk for the London market than does the passporting issue, the Eurozone needs to remain outward looking to facilitate international trade and to ensure that its businesses have access to international finance denominated in euros. "The purpose of our legislative proposal is to ensure financial stability and not moving business for the sake of moving business", according to Valdis Dombrovskis, the European Commissioner responsible for financial services.

> The voices in the EU that called for compulsory repatriation seem not to be in the ascendency at present.

If the Commission's announced approach is retained, it will both increase the prospects for continued business outside the EU and enhance the ability of EU businesses to access the capital they need denominated in euros, rather than US dollars or the renminbi.

RATE OF NON-PERFORMING LOANS (AS AT DECEMBER 2016)



Opportunities for other financial centres

Brexit has been an occasion for international banks to look at their global operations. It is thought that major financial centres in the US and the Far East may see certain activities currently or exclusively performed in London repatriated by their banks, if they can be done equally effectively back in the home jurisdiction. The recovering US economy, the prospect of lightening the burdens of Dodd-Frank currently under discussion in Washington, and the growth in increasingly-sophisticated markets in the Far East may offer opportunities for banks that are worth investing in.

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Fintech: to regulate or to partner...that is the question

As discussed in our earlier article "Forecasting five fintech developments", new technology is revolutionising the way we live, work and communicate.

The proliferation of fintech comes at a time when regulators across the globe are significantly increasing their oversight over the banking sector, implementing new regimes with personal accountability and financial consequences for senior managers and executives within banks. These regimes have been introduced in the UK and Hong Kong, with substantially similar regimes soon to reach Australia and potentially Singapore.

At least to start with, these regimes have not imposed, or do not propose to impose, a corresponding level of regulatory supervision over fintech companies which are not involved in regulated activities.

> While governmental and regulatory encouragement for innovation seems to be at its peak, is it now time to revisit this regulatory disparity?

In the meantime, banks have started asking: what is the best way forward in the current regulatory environment, in light of these emerging fintech companies? Key learnings from the US have shown that perhaps the best way forward is to stop seeing fintech as "competitors" and to start considering them "partners".

Is there a rationale for regulation of the fintech industry?

In the UK, the Financial Stability Board, the international body that monitors and makes recommendations about the global financial system, is currently assessing how the development of fintech might be affecting the resilience of the financial system, identifying risks (including systemic risks) associated with existing financial institutions and activities, and assessing how these may arise within the fintech sector.

US$9.8 BILLION

loans issued through P2P lending in the US in 2016[1]

Regulators are trying to balance opening up the market to new entrants and preventing systemic risk. Bank of England Governor, Mark Carney, believes that although "there is nothing new under the sun", there needs to be a disciplined and consistent approach to similar activities undertaken by different institutions which give rise to the same financial stability risks.

START-UPS[2]

800 APR 2015

2000 FEB 2016

It is clear that some in the P2P sector are actively seeking out further regulation. Indeed, the UK regulator (the Financial Conduct Authority) signalled at the end of 2016, following a review into the sector, that it was looking to increase regulation due to concerns of a lack of regulation.

To some extent, the level of increased regulation will depend on whether it is acceptable for investors, through fintech, to bear more of the risk when compared to bank depositors. Even where investors accept that there is increased risk for them to bear in taking advantage of offerings such as P2P lending, there is always a distinction between acceptable and unacceptable risk (caused by failures within the organisation).

> UK, peer-to-peer (P2P) lending now represents around 15% of new lending to SMEs.

The question arises as to how such failures and unacceptable risk can be avoided, and how employees can be discouraged from acting in a way which might give rise to failures. Could senior employees, for example, be held personally accountable for their business areas as a way of increasing regulation and helping address (to some extent) where the risk profile lies within the fintech economy? Should there be direct financial and career-impacting consequences for those involved?

How does personal accountability work within the banking sector?

The global financial crisis and the UK regulator's inability to take action against banking employees guilty of serious misconduct was one of the catalysts for the introduction of the Senior Managers and Certification Regime (SMCR) in March 2016, applying to deposit taking banks, building societies and credit unions.

The most senior employees in the bank, so-called "senior managers", are now personally responsible for the area of the bank they run and are required to take reasonable steps to prevent

regulatory breaches. The idea is that senior managers set the tone from the top, changing the culture and ensuring appropriate supervision of their area of the bank.

The Parliamentary Commission on Banking Standards recommended implementation of the SMCR to obtain greater precision about individual responsibilities than the previous approved persons regime and as a means of upholding individual standards of behaviour. Ultimately, the UK regulator can take enforcement action against a senior manager personally and censure and fine them.

NEARLY $23 BILLION

of venture capital and growth equity has been deployed globally to fintech companies over the past five years, and this number is growing quickly: $12.2 billion was deployed in 2014 alone[3]

Our experience has shown that it has not always been a smooth road for the banks in encouraging senior employees to take on the role of a senior manager. In some cases, changes to reporting lines have been necessary to ensure those taking on a senior manager role have the requisite control over the business area for which they are now personally responsible. Banks have also received requests from senior managers for legal advice to understand the consequences of their new roles and requests for extended directors & officers insurance and indemnities to mitigate some of the risk.

The next level below senior managers are so-called "certified persons" whom the bank (rather than the regulator) must annually certify as fit and proper to undertake their role. These are people undertaking significant harm functions within the firm and are often individuals who were approved persons under the previous approved persons regime.

In addition, almost all employees are bound by conduct rules which apply a new standard of behaviour. This means acting with integrity, due skill, care and diligence, treating customers fairly (having regard to their interests), observing proper standards of market conduct and being cooperative with regulators. Breaches by employees are notified to the UK regulator.

Personal accountability as a concept is spreading through those jurisdictions with a large financial services sector.

In Hong Kong, the Managers in Charge regime (MIC) was introduced in December 2016, with MICs to be appointed by 17 July 2017. Similar to the UK senior managers regime, this regime contemplates that MICs, as part of senior management, should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. MICs may also be held personally responsible for failure within the business units for which they are responsible, taking into account the degree of responsibility they have and their apparent or actual authority in relation to the particular business operations. Like in the UK, the role of MIC is in addition to, and does not replace, the existing roles of the Board and the Responsible Officers of the firm.

Australia and potentially also Singapore are the next jurisdictions looking to introduce similar regimes. Our experience in assisting various banks with implementing the UK and Hong Kong regimes shows similar issues arise, regardless of the jurisdiction, where personal accountability is introduced: ensuring there is early buy-in from the senior employees who will take on personal responsibility (to avoid not being able to put them forward for the role and then having to restructure part of the business), tackling thorny issues like remuneration, insurance arrangements and indemnities, being prepared to answer the question of how the firm will help the employees comply with their role (what systems and controls are in place and what budget they have to ensure appropriate delegation, supervision and circulation of management information) and deciding how collective decision making can work within a personal accountability regime.

Can and should this approach be taken with fintech companies, including P2P lenders?

At least in the UK, the answer is "YES"! The SMCR is being extended from 2018 to all sectors of the financial services industry currently caught by the approved persons regime. This will include P2P lenders who are currently regulated by the UK's Financial Conduct Authority (FCA), as well as asset managers, hedge funds and wealth managers.

1 https://www.bloomberg.com/gadfly/articles/2017-03-24/failed-wedding-lender-promise-financial-shows-honeymoon-s-over
2 http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology
3 http://www.mckinsey.com/industries/financial-services/our-insights/cutting-through-the-noise-around-financial-technology

In July 2017, the FCA released its consultation paper confirming that the same broad structure will apply. In particular, firms will need to have senior managers who will be personally accountable for any failures in their business. In relation to "certified persons", employees of P2P lenders, like Funding Circle and Zopa, who are currently subject to the approved persons regime will already be used to fitness and propriety assessments. Going forward, however, it will be the firm, not the regulator, making the assessment under the SMCR.

Will the UK start a trend for more personal accountability of fintech senior staff in other leading financial centres?

The MIC regime in Hong Kong is limited to licensed corporations who are subject to regulation by the Securities and Futures Commission (SFC) (including fintech providers who undertake regulated activities in Hong Kong), and while it is expected that the Hong Kong Monetary Authority (HKMA) will in time review its existing senior manager regime to align more closely with the MIC Regime, no plans to extend the provisions more broadly have been published.

The proposals in Australia are focused on the banks, rather than fintech companies.

It therefore seems the answer is "not yet".

> "Regulation [of banks] will continue and will probably get even tougher."
>
> **DAVID GONSKI AC CHAIRMAN OF THE ANZ BANKING GROUP LIMITED**

We asked John Walsh, Partner at McKinsey & Co and a specialist in US financial regulation, whether he thought such laws would be implemented in the US.

His answer was clear – in the current regulatory environment, legislation in this area is unlikely in the US and the country would most likely take a "wait and see" approach until and unless an incident of "egregious" conduct by a fintech company occurs.

Pertinently, Chairman of the ANZ Banking Group, Mr David Gonski AC, remarked on this trend of increased regulation stating that "regulation [of banks] will continue and will probably get even tougher." In this vein, Mr Gonski considers that such regulation should be extended to fintech in Australia, emphasising the need to protect small consumers and that a failure to do so would result in tears.

What about hitting senior employees in the wallet to disincentivise poor behaviour?

The proposed new regulation in Australia of senior employees doesn't just focus on personal accountability if something goes wrong, but also introduces more regulation of those employees' remuneration. At this stage, there is scant detail, other than that up to 40% of variable remuneration will need to be deferred.

Deferral in itself is unlikely to drive behaviours, but what has been seen in other jurisdictions is the use of remuneration deferral as a mechanism to link remuneration to performance (by deferring into equity) and to provide an ability to reduce deferred amounts where past failures come to light.

In Europe, there has been stringent regulation on the remuneration of material risk takers in banks for several years, aimed at curbing excessive bonuses which were viewed as encouraging risky behaviour. Indeed, the UK regulators have gold plated the European regulations, requiring the deferral of senior bank employees' remuneration for up to seven years during which time that remuneration is "at risk", with at least half of it linked to share price movement. In addition, even once vested and paid, that remuneration remains at risk for up to a further ten years during which it may be clawed back by the bank.

While these arrangements apply to all European banks and investment firms (in particular those which have permission to hold client money), the rules have been implemented to apply on a "proportionate basis": only the largest institutions need to apply the rules to the fullest extent, while smaller banks and investment firms may disapply many of the rules. There are, however, proposals to remove the ability for regulators to allow disapplication of the rules by all but the smallest firms. So it is likely that we will see greater levels of deferral in the future.

In Hong Kong, deferred bonuses which are subject to forfeiture and/or claw-back mechanisms are common in the financial services industry, although they are not mandated in the same way as in Europe. That said, both the HKMA and the SFC have adopted guidelines or otherwise encouraged firms they regulate to adopt remuneration practices which are consistent with the Financial Stability Board's Principles for Sound Compensation Practices and its implementation standards.

What does this mean for fintech?

At least for the moment, many fintech companies, in particular P2P platform firms, have not been viewed as systemically important enough to require the rules to be extended to them. This may not continue to be the case as the industry develops. Indeed, within Europe, while the first wave of regulation affected banks and investment firms, it was not long before asset managers and insurers received their own set of regulations. Remuneration is always an agenda item, and it will only need the first failure within the fintech sector for minds to focus on this aspect of regulation.

As the SMCR does not deal with remuneration, the extension of the regime to all financial services institutions in the UK from 2018 means that the stick of personal accountability will apply but restrictions on remuneration will not. Will that be enough?

General trend of regulatory disparity with fintech

The regulatory disparity between banks and fintech regarding senior manager regimes is indicative of a more general regulatory trend in certain jurisdictions. Namely, a governmental and regulatory desire to promote innovation has seen a lack of regulation over fintech, and in some cases, a substantially more favourable regulatory treatment for fintech companies.

To take the Australian example, the government recently proposed legislative amendments that will expand the category of institutions permitted to describe themselves as "banks". Currently this term is reserved for registered Authorised-Deposit Institutions (ADIs) with more than A$50 million in capital. The amendments propose to remove this capital requirement, allowing all ADIs to call themselves "banks" with a view to levelling the playing field for new entrants into the market, which could include small fintech companies engaging in banking business who are registered ADIs.

Other examples of this regulatory favouritism are in the form of tax incentives for early stage investors in start-ups and a fintech regulatory sandbox, which allows testing of new financial products and services to occur in a regulatory vacuum for the first 12 months. This idea is similar to that introduced by the UK's FCA in 2015

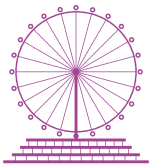
DOES THE SENIOR MANAGER ACCOUNTABILITY REGIME APPLY TO FINTECH COMPANIES NOT OTHERWISE INVOLVED IN REGULATORY ACTIVITY?

United Kingdom
NO*

Hong Kong
NO

United States
NO

Australia
?



Singapore
?

*Many fintech companies are regulated

which was taken up not only by fintech start-ups but also some of the largest banks wishing to test new products which do not fit within the current regulatory framework.

Further, in the Australian crowd-funding space, a recently passed law allows public non-listed companies (worth less than A$25 million) to issue shares to retail investors without going through the usual IPO process, effectively exempting them from the usual corporate governance measures.

Interestingly, this regulatory disparity is not viewed as an issue by all, particularly those who consider the market is best placed to take care of a lot of the heavy lifting itself, specifically, where fintech users are able to determine the levels of acceptable and unacceptable risk they are willing to take on.

Ultimately, as put by McKinsey's John Walsh, the fact that we are yet to see any egregious wrongdoing on behalf of fintech has meant that many regulators are taking a "wait and see" approach. While we will certainly see regulation in some parts of the world move towards applying to fintech, which would be a refreshing breath of regulatory fresh air, many jurisdictions are unlikely to cast such a broad net at this stage.

The best way forward: partners instead of competitors?

When considering the best way forward, we turned to several industry experts to gauge their thoughts. Mr Gonski explained that what fintech companies often forget is that, while they have good ideas, they need both capital and customers. This is what a big bank has to offer. Mr Gonski raised the growing trend of those strategically thinking fintech companies, who have realised that partnering with such a bank will improve their chances of success and longevity. In Mr Gonski's opinion, we will start seeing more of these partnerships going forward which will, in turn, lead to banks meeting their technology aspirations and the increased accessibility of these new fintech ideas in the market. This is already being seen in the UK, with banks like RBS partnering with FreeAgent, Funding Circle and Assetz Capital. Mr Gonski further considered that this trend would increase with a more level regulatory playing field.

Mr Gonski explained that what fintech companies often forget is that, while they have good ideas, they need both capital and customers.

Mr Walsh agrees with this contention and believes that banks in the US are already "using and deploying" fintech companies through a range of structures, such as joint ventures, consortiums, acquisitions and service agreements. The fintech company takes care of the back and middle-ends, leaving the bank free to concentrate on the customer-facing front-end where they can really add value.

The best way forward seems to be for banks to enter into strategic partnerships with fintech companies, in order to benefit from their own capital and customer base, while leveraging the innovative ideas and technology of their fintech counterparts.

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Regulatory change: the role of the in-house team

Many banks - in truth, probably most banks - struggle with managing regulatory relationships and regulatory change.

That is not simply because of the volume of change in recent years, although that has not helped. First, for globally active banks, there is the challenge of "keeping up" with the literally thousands of changes from hundreds of regulators each year. Every change has to be assessed for impact often before the reform is complete. Once an assessment is made, implementation can be complex, time-consuming and expensive: it can be difficult to find an "owner" for the change program, a difficulty that tends to increase together with the number of business areas impacted and the geographic scope, the complexity, of that impact.

In-house legal departments have rarely been at the forefront of managing these changes; in some banks tending to dip in and out, expressing views on complex points of interpretation or attending occasional meetings with external advisers. In many cases, the in-house teams tended to steer clear of whole subject areas, such as prudential regulation until, in recent years, they were confronted with capital add-ons for what regulators perceived to be the poor management of legal risk.

Against that background, the *Global Bank Review* asked three senior in-house lawyers to reflect of the experience of the past few years and look ahead to the challenges to come. Maria Leistner (ML) is General Counsel, Wealth Management at UBS; Michael Herring (MH) is Group Legal General Counsel at Macquarie Bank; Joe Longo (JL) is General Counsel, UK and EMEA at Deutsche Bank AG.

Looking back over the past decade, what has been the biggest change in the role/approach of in-house legal teams?

MH: In the securities and banking industries, adapting to wholesale change in the regulatory environment has been the biggest change for in-house counsel. The regulatory impact has seen significant structural change within many of the traditional bastions of those industries.

ML: The job is very different from 10 years ago! The advice role is assumed; now it is much more about joining the dots; risk identification. We have to be plugged into the business and understand the overall bank, its entities and its growth strategy, to identify the risks pertinent to an area and to help to mitigate that risk. By the way, the same is true for the external legal advisers to a bank.

JL: The whole operating model has changed. We have got a lot more interested in project management; use of a much wider range of resources; having to deal with much more regulatory and audit scrutiny of how we do our job and how we manage legal risk. The overwhelming governance looking into everything we do has transformed the life of in-house lawyers. And then, of course, there's the substance. It is a time of heightened regulatory and litigation risk: not just domestic but cross-border as well.

What do you expect the biggest challenge to be for in- house legal in the next five years?

MH: Technological change is most commonly cited, although I expect its impact will be far less on the legal role than the potential disruption to the corporate's core business. So, for in-house legal, the biggest challenge remains the same—providing proactive advice and support to help the business grow with confidence in the midst of complex markets, and at the same time protecting fundamental corporate and employee rights against regulatory and litigious creep and overstep.

ML: The first challenge is how to remain relevant. If you look at the stats for applications it seems people don't want to become in-house lawyers at banks. Relevance has to be assessed in light of the external products, services and providers at various levels. So much of the standard processing and operational work can be supported more cheaply and efficiently by others, leaving the in-house lawyer to focus on helping to shape culture and risk appetite.

> "There has been a big difference in the level of regulatory engagement."
>
> **MARIA LEISTNER**
> **GENERAL COUNSEL, WEALTH MANAGEMENT, UBS**

How do we get in-house lawyers to play that new role? We have people raised on giving advice in a reactive manner but that leads to irrelevancy. Legal can't see itself as sitting wholly in the first line or the second line of defence. It cannot be just a facilitator or enabler function; it must play a strategic role.

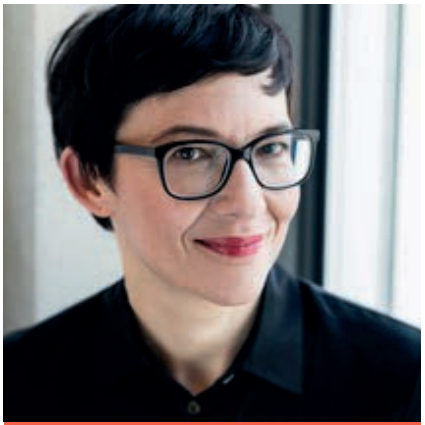
JL: The big issue facing in-house legal departments and law firms too is where technology is going to take us. There is a lot of talk about the use of automated systems and artificial intelligence to produce documents and to deal with data. That is a challenge that we are at the beginning of understanding. For a lot of the lawyers, the next transformation is to understand and engage with technology.

And I think there is a resource crunch. Organisations are increasingly cost conscious and they expect the legal department to be run very efficiently and with tangible evidence of controls and systems around cost and not just risk. And obviously that includes external costs as well.

And there is the need to be on top of regulatory change. For a lot of lawyers, that took a while to sink in: they couldn't just do deals. They actually had to understand the regulatory environment in which those deals were getting done.

Again, looking back over the past decade, how would you describe the changes you have seen in the approach taken by regulators?

MH: It has been considerable, both in their approach and constitutional makeup. Regulators are now far better funded, better coordinated domestically and internationally, significantly more



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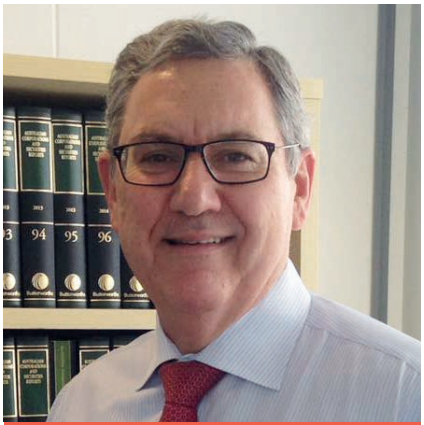

Joe Longo
General Counsel, UK and EMEA
Deutsche Bank AG

invested in regulatory systems and analytical surveillance tools and are far more attuned to advising their expectations "ex-anti" (before the event). And mostly for the better, there is increasing harmonisation of international laws to facilitate doing business globally, but it can be a trap when regulators play leap frog by simply replicating other countries' regulation when seeking to elevate standards and conduct.

ML: There has been a big difference in the level of regulatory engagement. There are real benefits to the extra transparency we have seen from regulators. When we bring issues to their attention, the regulators are no longer in need of constant education. Of course transparency can lead to inquiry and investigation and the regulators are better resourced and, at the more senior levels, there are more with industry experience. My impression is that regulators are less inclined to panic and are trying to come to a better more substantive understanding of issues.

> "There is a real trend for those regulators to talk to each other a lot more; a lot more systematically; a lot more effectively."
>
> **JOE LONGO**
> **GENERAL COUNSEL,**
> **UK AND EMEA DEUTSCHE BANK AG**

JL: I have spoken about heightened regulatory risk from domestic and cross-border investigations and on the advisory and transactional side, it doesn't feel as if regulatory change is slowing. And then of course Brexit itself, if you are sitting in the UK, is creating a whole lot of new work essentially driven by changes in regulation and the operating model and its legal foundation.

The regulators we have to deal with are far more intrusive. There is a real trend for those regulators to talk to each other a lot more; a lot more systematically; a lot more effectively. That's driven another dynamic: you can't just deal with one regulator without thinking of everybody else. You might have a UK problem in which a dozen other regulators in other jurisdictions also have an interest. And the message you give to each has to be nuanced. And then there is a legal framework about what you can and can't say.

How (if you think they have) have banks changed the way they interact with their regulators?

MH: Over the past years, banks and regulators have each changed the way they interact, with lessons learnt by both over the years. Regulators are helpfully prompting banks into action far earlier to head off potential trouble spots and, where regulatory change is likely to impact markets, we are seeing more constructive consultation.

ML: I don't think any bank has been fully successful in its model for dealing with regulators and regulatory changes. Banks haven't necessarily got the engagement model right. Regulators want to deal directly with the people who have the information: the business, the Risk Department and so on, not have the message intermediated. Regulatory change remains the biggest single risk.

JL: It's been a revolution. Pre-global financial crisis most in-house lawyers didn't take much interest in regulation or in capital or in liquidity, or the key ratios that allow banks to be prudentially supervised. Post-global financial crisis, I think it has been an extraordinary transformation: most of our in-house lawyers need to have a working understanding of the regulatory changes that affect them and the businesses they support.

It has been a real challenge and transformation for in-house legal and the businesses to take it seriously: regulation isn't someone else's problem or Compliance's problem. To do your job properly and to have a sustainable business model, you have to understand how the rules work and what how you need to change to comply with all the regulation so you can still make money.

Do you think regulators have the balance right between supervisory dialogue and enforcement action?

MH: In recent years, the balance is steadily improving towards supervisory dialogue. It is no doubt a function of the breadth and speed of recent regulatory change, the front-ending of potential regulatory issues, and the fact that corporates generally wish to be at the vanguard of responsibility for their own risk management.

> "Over the past years, banks and regulators have each changed the way they interact, with lessons learnt by both over the years.
>
> In recent years, the balance is steadily improving towards supervisory dialogue."
>
> **MICHAEL HERRING**
> **GROUP LEGAL GENERAL COUNSEL**
> **MACQUARIE BANK**

ML: Trust is slowly returning because of transparency. But I think regulators remain concerned about whether banks are changing fast enough, a concern shared by Boards and shareholders. It's a multi-year program: risk awareness, effectiveness. Historically, some regulators did not have people who could properly assess progress and it still varies a lot from country to country but I think we coming towards the right balance.

JL: There is no doubt the dialogue with regulators is continuous and intense. The question of balance between supervision and enforcement is to some extent institution specific but I think most regulators are reluctant not to take enforcement action if they think there has been a material breach. They are not "shooting" us for everything but I think most regulators believe that to remain credible and to meet public and government expectations of what a regulator should do, they can't be seen to just be taking a prudential or supervisory approach. They need to be seen to be actually imposing penalties and, of course, in particular holding individuals accountable.

Leveraged finance – history repeating or a new game?

Around the globe, once again we see private equity sponsors benefitting from good liquidity and largely dictating debt terms. In some respects, terms are as loose if not looser than those at the height of the last credit boom in 2007. The years during and immediately post financial crisis when banks enjoyed a greater level of creditor protection through debt terms are a distant memory.

So what are the key themes in global leveraged finance and what are we seeing at the moment?

Key themes and drivers

Rise in activity

Despite uncertainty and volatility in financial markets, there has been an overall uptick in private equity activity levels across many markets worldwide.

This growth in activity has mostly been fuelled by acquisitions (with an increase in both volume and value of leveraged buyouts) as sponsors, buoyed by increased fundraising and debt availability have moved into a buy cycle following higher exit activity in previous years. Private equity's attractiveness as an asset class is resulting in high levels of dry powder, helping to fuel competition for assets.

The strong competition for quality assets and the entry of new players has seen international and domestic private equity houses adopt broader mandates, both in respect of deal size and assets.

In Australia, this has meant that international sponsors are more frequently competing with local players at the lower end of target deal size. On the other side, co-invest transactions are becoming more common and are allowing others to step up in deal value. Despite private equity's customary focus on control transactions, minority transactions and a wide range of other transaction types are becoming increasingly common.

In Australia, private equity's contribution to M&A activity has jumped in the last year fuelled by a return of large and upper mid-market deals. A similar dynamic is at play in Europe.

In the US, the trend of increasing M&A is also clear, with strong sponsor activity driving more aggressive terms for term loans and high yield bonds where convergence of covenants is seen in the rise of term loans B (TLB), which provide a floating rate option with covenant terms converging to high yield bonds which typically are offered as fixed rate instruments.

Liquidity and more sources of funding

High levels of debt liquidity remain a standout feature of the European, US and Asia-Pacific leveraged finance space. Underwriting appetite is strong. The entrance of non-bank lenders has exacerbated matters, with oversubscription a common feature for strong sponsors and investment grade corporates, although the required equity subscription remains sensible.

The liquidity pool is continuing to grow with the addition of new direct lenders and existing direct lenders raising new funds, and the trend is set to continue as the US interagency guidance on leveraged lending (the US Guidance) and soon to be in effect ECB guidelines supervise the lending practices of affected financial institutions. Some of these direct lenders can write increasingly large cheques, enabling them to fund some of the larger deals without much involvement from traditional lenders. These new lenders are helping to ensure that competitive tension remains high.

However, many of these newer players have limited experience with assets in financial distress, so it remains to be seen how they will behave in restructuring discussions when the cycle turns. In addition, these new players typically are not able to provide letters of credit and other ancillary facilities to ensure the full spectrum of liquidity requirements that may be required in a full-scale financing. For this reason, some sponsors have indicated they are cautious about using these new sources of debt.

New products

The proliferation of new debt providers has been matched by growth in available debt products. Sponsors can consider an expansive range of financing options: senior, stretched senior, mezzanine debt, holdco PIK, TLB, unitranche (which remains popular in Europe and is developing in Australia) and second lien loans in the US. Where there are such options and a wide number of market participants it is no wonder that debt terms are becoming more borrower friendly.

What are we seeing?

Looser terms and convergence of products

The two key trends have been looser terms and convergence of concepts across different markets and products. As investors trade covenant and other protections for yield, private equity is taking advantage.

In Europe, the change is stark. The market dynamics are such that terms are looser than ever before, other than the thickness of the equity cheque.

Many of the larger leveraged finance transactions do not contain any maintenance financial covenants and are done on "covenant lite" terms. If there is a financial covenant, it is likely to be a single leverage test with significant headroom of 30-35% and equity cure rights. For a US TLB loan, the financial covenant would typically only apply to the revolving tranche and on a springing basis.

Most sponsor documents now include detailed provisions dealing with additional or "incremental" debt. This typically includes acquisition debt for permitted acquisitions, any acquired debt, any

CASE STUDY

New products

An interesting case study on how this is playing out in Australia. Initially there was a spate of corporates and private equity transactions financed through the US dollar and New York law TLB market. This put pressure on the banks to compete against a real alternative financing. This is now evolving into an emerging Australian dollar (and increasingly, Australian law) TLB market. Investors include Australian insurance and superannuation funds, global credit funds with a presence in Australia and off-shore high-yield loan and bond investors.

The ability of Australian borrowers to access the US TLB market and now to access Australian dollar TLB products provide borrowers with much greater financing options. The Australian TLB market is becoming an attractive option for borrowers seeking the benefits of the US TLB product without the cost, complexity or risk of cross currency swaps. This competition of course puts pressure on financiers to provide more borrower friendly terms, and the covenant-lite approach of the TLB is increasingly finding its way into other products.

refinancing debt and further incremental debt. There is usually no fixed monetary cap, but instead an overall limit determined by reference to leverage.

There is also more flexibility over permitted payments and dividends. The leverage level at which any dividend is permitted is gradually being pushed upwards and separately a "restricted payments builder basket" is sometimes being incorporated. This basket allows dividend capacity to build up from items such as retained excess cash flow and disposal proceeds which are not applied in mandatory prepayment; more aggressive transactions would follow the high yield bond custom to use 50% of the consolidated net income to build the basket.

"Permitted Acquisitions" have also become more flexible and are often governed by a leverage test instead of an absolute cap. Although lenders have managed to hold on to the sanctions condition, in general the list of conditions has reduced and may otherwise be limited to:

- no Event of Default
- similar business
- no negative earnings above a certain threshold, and
- the provision of third party diligence reports (only if commissioned by the borrower).

Increasingly, sponsor documents are importing the "Excluded" or "Unrestricted" Subsidiary concept from the high yield bond market. This allows the borrower to designate certain subsidiaries as "unrestricted" which excludes them from the "Group" concept and therefore takes them outside the control of the covenant package. The flip side of this construct is that the EBITDA of those subsidiaries cannot count towards the EBITDA side of the equation in the leverage covenant (if there is one) and one would normally expect to see parameters around the quantum of permitted investment and therefore leakage into those entities.

Security packages are being scaled back further with tighter security principles. For term loans and high yield bonds, security is customarily limited to share pledges over obligors, material bank account pledges and security assignments of material intercompany receivables.

Following the US trend, the European market is becoming more commoditised even though there are different insolvency regimes across Europe. A key challenge for lenders is sponsors producing the same document regardless of the jurisdiction or sector, reflecting their strength of bargaining power. In particular, intercreditor documentation marks a major difference between the US and European markets. In the US, concepts of standstill, release of junior debt claims and debt purchase options are not included in intercreditor documentation as Chapter 11 of the US Bankruptcy Code mandates restructuring tools that provide certain protection.

It remains to be seen whether all of these terms will be reflected in other markets to the same extent, but the trend lines are similar.

Leverage levels – ECB guidelines providing some curtailment across the globe

Across the globe leverage levels have been increasing. Still, ECB guidelines which become applicable in November 2017 may provide some curtailment.

The ECB guidelines published on 16 May largely follow most of the principles of the US Guidance with one significant difference, in that control of the borrower by a financial sponsor is not included as a factor defining leveraged loans under the US Guidance. As for the US Guidance, the ECB guidelines state that syndicating transactions with high levels of leverage (defined as greater than 6x total debt to EBITDA at deal inception) should remain exceptional. They go on to say that for most industries, a leverage level in excess of 6x total debt to EBITDA raises concerns. The definition of EBITDA is expanded to say that any enhancements to EBITDA should be duly justified and reviewed by a function independent of the front office. This opens the door to adjustments, but also suggests that they need to be appropriately scrutinised.

Given the rising leverage multiples in 2017, these guidelines are causing concern for those lenders bound by them. From speaking to market participants, it may mean that undrawn facilities (such as revolving credit facilities) are reduced.

Even in jurisdictions including Australia where leverage multiples have, as compared to Europe and the US, been relatively subdued, we are seeing leverage multiples increase. The ECB guidelines will provide some restraint on this to the extent the financier is subject to them.

Sanctions

Sanctions continue to be a challenging area. Increasingly aggressive enforcement action (especially by US sanctions authorities), has resulted in greater attention on sanctions and prolonged negotiations of relevant provisions. Most international banks have implemented extensive internal compliance programs, including policies that require specific sanctions provisions to be included in loan documents, which may vary between banks. However, in the leveraged finance market, as with other terms, sponsors have been looking to propose their own drafting. The sponsor version will be "borrower-friendly", work from an operational perspective for their business and likely follow the same drafting used in other deals to maintain consistency across their portfolio. While lenders will still push hard on sanctions provisions to ensure that they have sufficient protection in relation to, for example, use of proceeds and the inclusion of a sanctions condition within the "Permitted Acquisition" criteria, the recent trend has been for lenders to have to seek certain internal policy waivers and in those areas rely more heavily on their due diligence.

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For good credits, borrowers are in the fortunate position of being able to compare various debt products to determine what best meets their needs for a particular asset – be it greater leverage, reduced debt paydown, covenant loose or lite, operational flexibility or pricing. The emerging Australian dollar TLB market is providing yet another option.

Padlocking the safe in a digital world

Cyber security is a constant and evolving threat across all sectors of the global economy. No bank is immune.

Given the impact that a cyber incident can have on brand reputation, customer confidence and business interruption, it's unsurprising cyber security has risen rapidly up the agenda for executives, with boards increasingly involved in key decisions around cyber risk. Yet in a recent global banking risk management survey, less than half of respondents considered cyber security to be a "top-three" concern.

Cyber security is bigger than an IT issue

With increasing frequency and sophistication around cyber security attacks and hacks, banks are appreciating that it is not an IT issue but a business continuity, financial and reputational issue which requires multi-disciplinary responses.

With organised criminals increasingly using cyber to "go after the money", banks will continue to be targeted. The former director of global technology production at Deutsche Bank, John Baird, is reported as having said that while all banks are constantly being scanned for cyber weaknesses, "more serious" incursions happen around once a month.

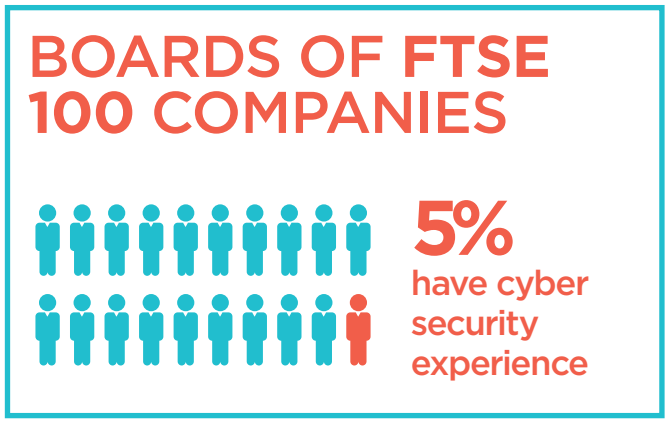
Speaking earlier this year at a cyber security event in Sydney, the ASX's head of technology governance Daryn Wedd emphasised the importance of companies coming together to manage the risk:

> "There is no point having an IT or tech team that is sitting buried in a room with technology, with all of the equipment and all of the gadgets and all of the kit you could possibly imagine, if that [security] information does not get used to inform the organisation as to what the threats are, and potentially what you need to do to combat them."

A new cyber mindset

Increasingly, compliance obligations are being imposed by legislators and regulators in relation to data breaches and other cyber incidents, and directors face growing threats of individual liability and shareholder class action. Despite this, only 10% of FTSE 100 companies currently deliver cyber-risk training to their board and just 5% of boards have any cyber security experience.

In Australia, mandatory notification of data breaches will come into effect in early 2018. In Europe, the General Data Protection Regulation (GDPR); coming into effect in May 2018 will require mandatory reporting of data breaches within 72 hours, and the Network and Information Security Directive will mandate minimum cyber security standards for providers of critical national infrastructure. Banks supervised by the European Central Bank are set to face breach notification rules similar to the GDPR.



Fortifying the defences

Banks are investing in scenario planning and communications training to ensure the response team knows how to deal with the unexpected and has sufficient "flex" to respond to what is often an urgent unfolding cyber crisis situation.

Strengthening internal protections

The good news is many financial institutions are recognising the importance of treating cyber security as a "team sport". Focus is turning towards building cyber resilience through effective training and partnerships from board level down.

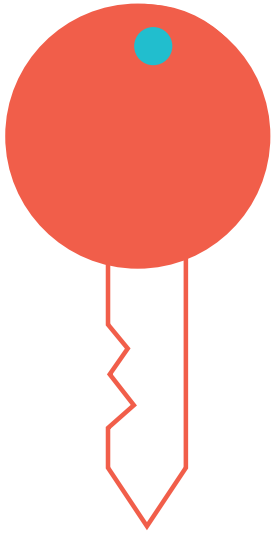
When cracks appear in the safe

One of the biggest data breaches in history was the exposure of names, phone numbers and email addresses of 83 million account holders when a bank's systems were compromised by hackers in 2014.

The recent Wannacry and NotPetya malware outbreaks disrupted industry supply chains, shut down hospitals and affected several banks. The Russian central bank was one institution hit by those attacks.

A hack of the Bangladesh Bank last year resulted in the theft of US$80 million (£63 million) via the SWIFT interbank payments system. The criminals had attempted to place SWIFT transactions totalling almost US$1 billion – the damage was only limited when a typo was spotted in one of the intended transactions. This breach led to urgent upgrades of the SWIFT system.

COMPANIES NOT ACTIVELY ENGAGING WITH **INVESTORS OR CUSTOMERS** ABOUT CYBER SECURITY



FTSE 350 companies
3%

ASX100 companies
32%

Contrary to common perceptions, careless or unaware employees are said to be the most likely contributor to cyber incidents, and therefore are one of the best lines of defence. After that, the most likely perpetrators are criminal syndicates, malicious employees and hacktivists, in order of decreasing likeliness.

Staff are being educated on how to avoid common scams, including the risks of opening unknown attachments or responding to "phishing" emails, leading to infiltrations of the corporate network or the introduction of malware causing a ransomware incident or another form of vulnerability.

Employee awareness is being improved though the "gamification of the process". For example, engaging third parties to send, with increasing levels of sophistication, fake phishing emails to employees, keep track of those who fall for them and then offer retraining and retesting to improve employees' ability to identify malicious emails in a "no-blame" culture.

Bolstering external safeguards

Supply chain outsourcing arrangements are also critical to effective cyber response capability.

Engendering the right behaviours both preventatively and when incidents occur is crucial. Without that, companies that experience cyber incidents originating from a third party supplier will discover that containment is more difficult because the supplier is uncooperative in attempts to contain the effect of the breach or determine its cause – including because of the prospect of subsequent litigation or further reputational risk.

As an example, banks should ensure their contracts spell out how they expect third party contractors to act in the event of a cyber incident. This might include provisions addressing information sharing (such as notification obligations and updates at defined intervals), incident response and mutual support in relation to containing any incident, and requirements that subcontractors sign up to similar provisions downstream.

Supply chain security (and vetting of suppliers) is vital as data processing and other critical business functions are increasingly outsourced or hosted in the cloud. Yet a recent ASX 100 cyber report found that 30% of the ASX 100 have still not assessed the security of third parties and 32% are not actively engaging with investors or customers about cyber security – vastly different to 3% for the UK's FTSE350.

It will be interesting to see how this evolves in the next 6–12 months when Australia's new mandatory data breach laws come into effect.

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