US Financial Regulatory Reform: Cost or Opportunity?

Impact of The Dodd-Frank Wall Street Reform Act

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Executive summary

The most dramatic regulatory reform since the 1930s is about to hit US financial services firms and it has substantial long-term and short-term implications for how they operate their businesses.

We predict that it will cost the industry between $3 billion and $5 billion over the next three years to implement The Dodd-Frank Wall Street Reform and Consumer Protection Act, which makes it a much more expensive proposition than other landmark regulatory reforms in recent years such as Basel II. We believe that the top and most systemically important bank-holding companies, insurers and mid-size banks will bear the largest expense, spending between $100 million to $200 million each in some instances, and we estimate that the hardest hit firms could also see profits fall between 20 percent and 30 percent. In fact, our June poll of 101 financial industry executives found that nearly half (49 percent) thought their profits would decrease as a result of the new Act.

As a result, the competitive landscape of the industry could look very different in five years time, and there will be clear winners and losers as firms are forced to hold more capital, capture and report much more data, measure and manage risks more efficiently, and spin off or wind down lucrative businesses such as swaps trading and proprietary trading. The most nimble and efficient retail banks, insurers and broker-dealers could prosper and pick up market share, while, without being able to rely so heavily on their proprietary trading income, the largest broker-dealers will have to drive down costs, increase efficiency and develop new customer-centric products and services—or shift their focus elsewhere.

Some capital markets firms will increase their push into retail banking to bolster their capital adequacy and compensate for lost revenue, while investment banks will likely shift to more commoditized, lower-risk, utility-type businesses. As hedge funds will also come under tighter regulatory reigns, a new generation of entrepreneurial financial services firms could emerge, creating a new vehicle for high risk investors.

Indeed, our June poll found that two-thirds of respondents (66 percent) believe the Act will require their companies to rethink their business models. Nearly the same number (62 percent) think it will require them to revise their long-term business strategies, while less than one-third (30 percent) feel it will have little or no impact. The top strategic priorities of these executives are tightening risk management, cutting costs, changing pricing structures, focusing on core competencies, and introducing new products and services.

Those firms that do not take the Act seriously or implement change efficiently could struggle, as we have seen firms labor under the weight of less significant reform in the past. For example, those firms that built the infrastructure they needed for Basel II compliance separately from their existing systems soon ended up spending more money integrating the two together. Combine the impact of The Dodd-Frank Act with other major new regulations, such as Basel III, and it is even more important that firms make efficient reform implementation a top priority.

The good news is that those firms that already run efficient businesses and boast low cost-income ratios, as well as those that already have a unique market position, possess a strong competitive advantage. Firms that use the implementation of regulatory reform as an opportunity to increase their efficiency, to rationalize their businesses, and to develop new products and revenue streams have a real chance to bolster their return on equity.

To do this, they need to take a step back and form a holistic view of both their operations and strategies to develop a master plan for what their businesses will look like in five years time. The firms that will come out on top will need to plan what their future business opportunities and competitive advantage will be under the new regulations, imbed reform implementation into their overall business strategy, and offset implementation costs by managing risk and organizing data at an enterprise level.

In this report, we explain how firms can put together that master plan to tackle this enterprise-wide approach to reform and how they can extract important business benefits from the key changes in this legislation for the lowest cost.

The reforms in brief

There are many moving parts to The Dodd-Frank Act that touch every financial services company operating today. Banks benefiting from federal guarantees will have to stop proprietary trading after a period of review, standardized derivatives will have to be cleared and traded on exchanges, while the more risky parts of derivatives businesses will need to put in a separately capitalized subsidiary. Systemically important financial companies will have to come up with funeral plans for their businesses and the largest banks could end up contributing to the cost of liquidating a rival.

Firms will have to hold more capital, reign in risk and compensation, and more regulatory oversight will increase reporting across the board. Firms will have to collect and analyze a lot more data on products, risk and capital in this environment of increased oversight, enhanced transparency and systemic monitoring of the industry. Hedge fund and private equity advisors will be forced to register with the SEC, credit rating agencies will be under much more scrutiny and the SEC will also impose a new fiduciary duty on brokers that give investment advice. A new Federal Insurance Office will monitor the insurance industry and undertake studies to look at future industry reform and alignment with international regulations.

Mid-size banks, monoline product companies and other financial services vehicles that were not previously bank holding companies will be subject to more regulatory scrutiny and greater compliance costs when, following a study, the rules for bank holding companies are extended. Mortgage lenders will have to meet much higher standards, companies selling securitized products such as mortgage-backed securities will have to retain some of the credit risk in the form of a capital charge on their balance sheet, and many medium and large financial services firms will have to implement new consumer-friendly services and report to the new Consumer Financial Protection Bureau.

As we can see from Figure 1, investment banks, systemically important insurance companies, universal banks and global financial services firms, followed by thrift and mutual funds, are likely to have the most changes to make to comply with these regulations and will incur the highest costs. Smaller insurance firms, brokers and hedge funds will be the least affected. Operating costs will likely increase across the board, so the companies that already have high cost-income ratios will be hit the most, while those that have the lowest cost-income ratios will have much less leg work to do to optimize efficiency.

Implementation as a business opportunity

The new Act brings a large number of diverse changes to the industry, but companies must think about the body of reform in its entirety, because of the broad scope of its impact and because the different elements of the new legislation are interrelated. For example, a bank's risk management and its compensation practices could look very different if its derivatives business is spun off or its proprietary trading operations are divested. This Act also overlaps with other pieces of reform legislation, such as the Alpha Regulations and the Securities Exchange Act (see Figure 2), which is another very good reason why firms should step back and consider all the implementation requirements across their businesses.

Furthermore, if these issues are tackled smartly, they also present new business opportunities for companies that will help mitigate implementation costs. If banks have to report every fee charged to retail customers to the new Consumer Financial Protection Bureau, they should include this information within their Customer Relationship Management platform and exploit this data to develop new consumer-driven products. If banks and insurers have to come up with a costly funeral plan to demonstrate to regulators how an orderly wind down of their businesses will work in the worst case scenario, this can also serve as an ongoing review of operations and an optimization plan for the company.

Figure 1. Change impact assessment

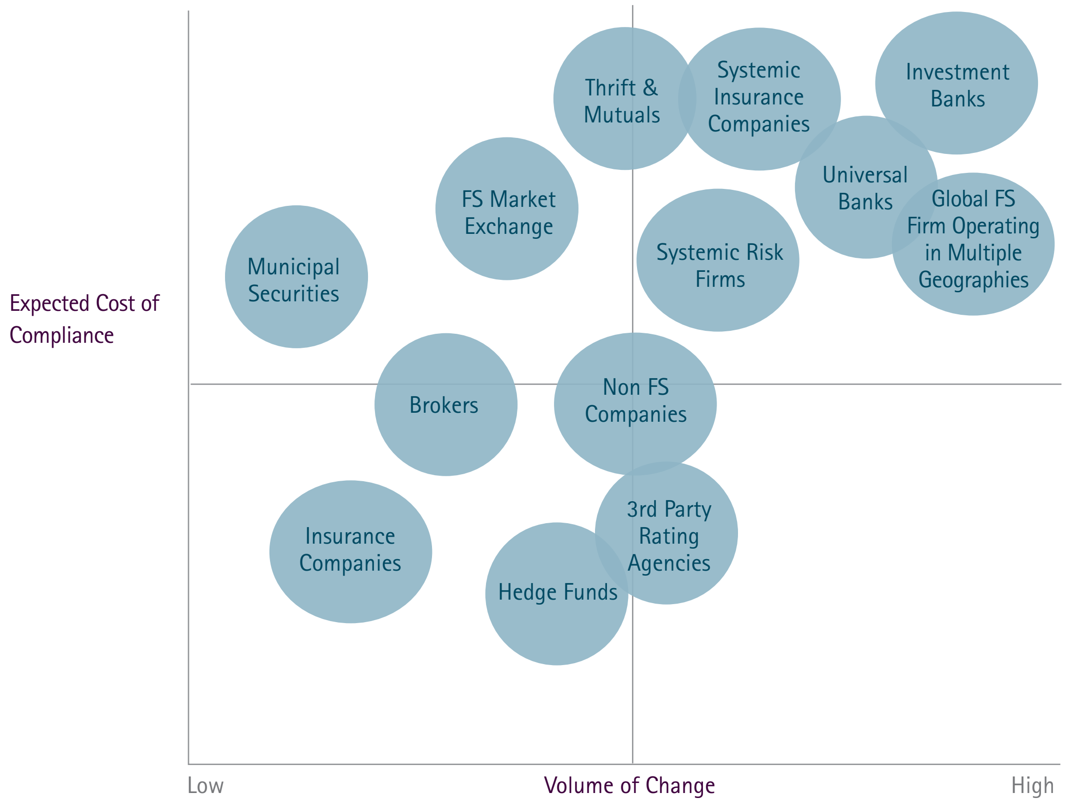
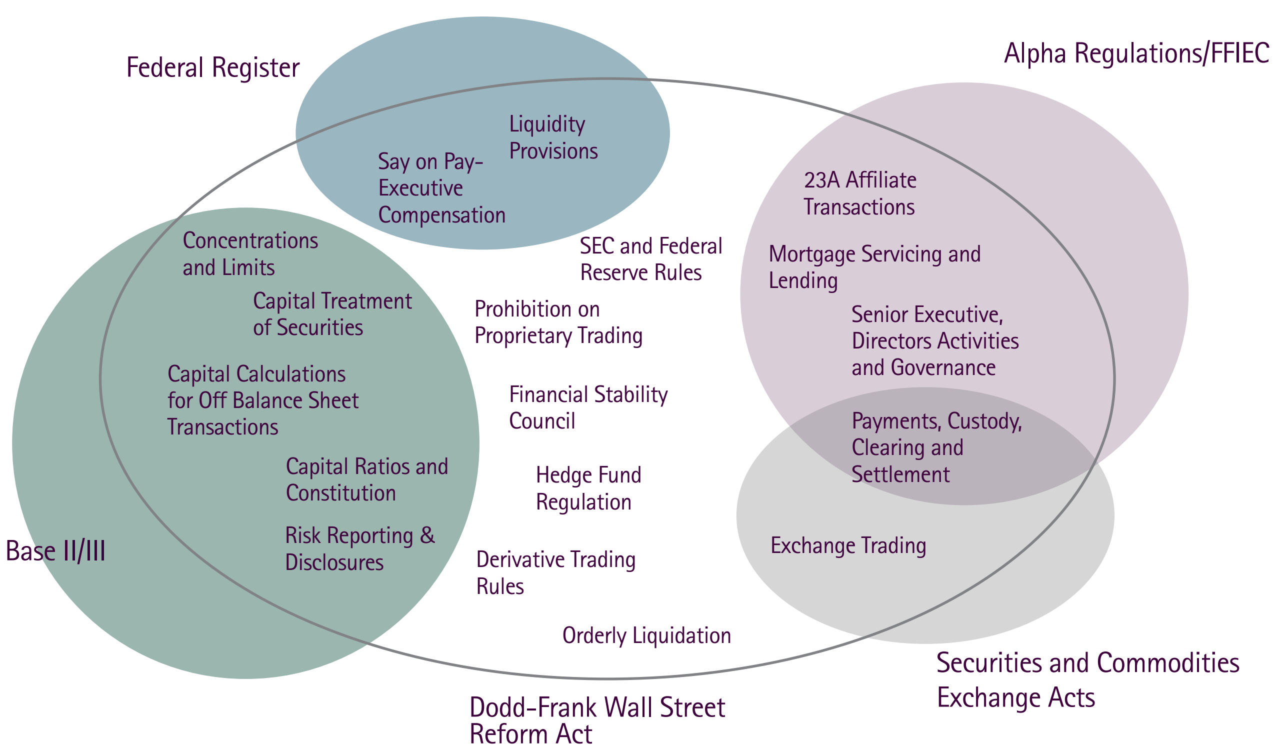


Figure 2. Overlap with existing regulation



Taking a holistic view: a five-year master plan

Now that the Act is signed into law, most of its provisions take effect immediately, while some are subject to study periods or longer implementation timetables. However, all its provisions come into effect by the end of 2013. To transform what would otherwise be a costly and onerous implementation exercise into an opportunity to drive return on equity and get ahead of competitors, firms need to address all of these issues together and to come up with a five-year master plan. This plan must incorporate strategic opportunities, rather than just addressing operational change.

They must decide what their future competitive advantage will be and what new business opportunities to pursue. The key question to address is, "How will I still have a lucrative business in five years time when I will have to supply much more information to regulators, some of my current businesses lines will be less profitable and my cost of capital will be increased?" What product lines and operational strategies will remain viable? What new markets, product lines and geographies will become attractive? Are there any arbitrage opportunities in moving parts of the business, such as derivatives trading, to less restrictive parts of the world? Can I differentiate the business by taking advantage of the new Consumer Financial Protection Bureau standards?

Then companies need to think about how they will implement this plan at the same time as complying with the new regulations using a single set of business process changes, new data attributes and systems changes. For example, the team creating an expensive data management system to funnel reports to the Consumer Financial Protection Bureau should not create a separate database that those in charge of consumer product development will never see. Similarly, an opportunity will be lost and a lot of money wasted if companies spend millions of dollars putting together a complex funeral plan that lies forgotten about in a drawer for 12 months at a time. This process should be integrated with continuous process improvements and risk assessment functions to drive change.

The lessons of Basel II

After all, we don't have to look back too far to see the perils of trying to implement regulatory reform in a piecemeal fashion. Those firms that built the infrastructure they needed to implement Basel II separately to their existing systems then spent even more money integrating the two together. However, those banks that incorporated their new Basel II capabilities into their overall business strategy, thought about capital in terms of managing the whole business and thought about risk in terms of pricing their products, came up with a much more efficient answer. It is even more critical that firms take a cohesive approach to implementation with The Dodd-Frank Act because the costs of implementation will be higher and the impact far broader, at a time when there are less profits to go around.

Creating a roadmap for implementing regulatory change

There are three steps that every company can take to implement these regulatory changes in a cohesive fashion.

Step 1.

Demonstrate mastery of your business. Demonstrate that you know your products, processes, people, technology, disclosure, risk management and capital requirements and how these link up within the structure of your organization. Be able to demonstrate your mastery of this information to regulators and to the marketplace. This information can be used to create transparency and meet other provisions, such as creating a funeral plan for the business.

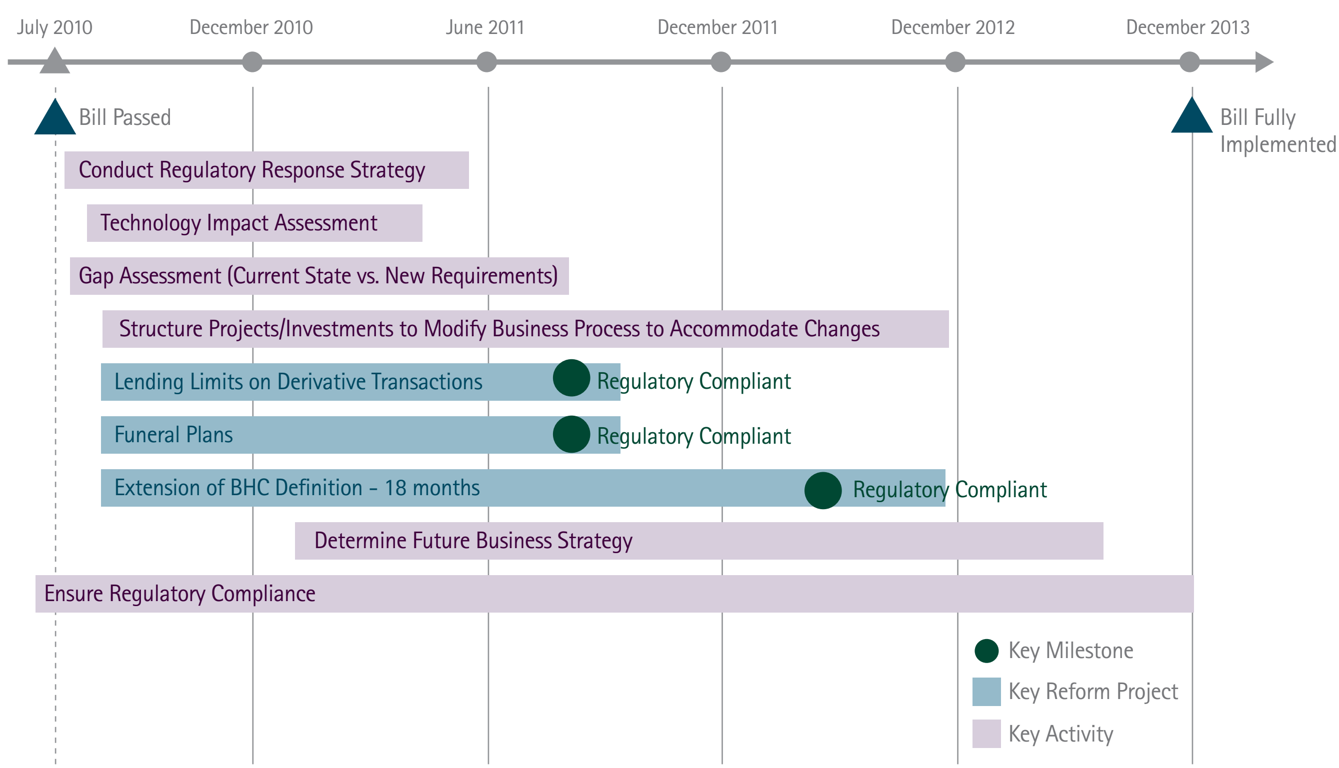
Step 2.

Understand and plan for change. Stress test your business mastery model to determine where its shortfalls lie. Which businesses or services should the firm exit or enter? How should it divest or reduce proprietary or high risk and high capital positions to save money and reduce scrutiny? Which products should it retain and how should they be reengineered to reduce capital consumption? How should costs be controlled to optimize financial performance? What new risks need to be monitored, measured and managed? What data capture, storage and reporting systems will meet the need for a more detailed and granular analysis of multiple portfolios and risk types? How will the company optimize capital and liquidity now and in the future and what are the contingency plans? How can all these necessary business process, data and systems changes be incorporated into a single program?

Step 3.

Communicate and execute those changes. Assess how you can address those shortfalls in the most time and cost-efficient manner across your business. What must each department do to make this a reality across the whole enterprise? Document this in a change roadmap, with deadlines for the execution of each element and how these capabilities can be matured over time, and communicate this message to regulators (see Figure 3).

Figure 3. Compliance roadmap



What will the key changes mean for your business?

To better understand the importance of a cohesive approach to reform implementation, we need to look at some of the core components of the Act in more detail and how they interrelate.

Derivatives businesses

Now that standardized over-the-counter derivatives will have to be cleared and traded on exchanges, swap dealers and major swap participants in the over-the-counter derivatives market will have to do a cost-benefit analysis to decide whether they have a big enough volume of derivatives business to make compliance worthwhile. They will have to make key strategic decisions, such as whether they transfer the business to another geography, exit the business or potentially sell their derivatives book to another company.

Previously, when the derivatives business was over-the-counter, it did not matter if firms only executed one contract a year, as overheads were fairly low. Now that derivatives are going to be traded on exchanges, firms will have to invest to build secure the electronic connectivity required for exchange trading, put up margin at the exchange, comply with exchange rules and execute trade reporting, including the registration of all swap interests with regulatory agencies.

Swaps dealers and some swaps participants that rely on federal assistance will also have to spin off the most risky parts of their derivatives businesses, including commodities swaps and some credit default swaps, into an independently capitalized subsidiary within two years of enactment. This will involve a thorough analysis of a firm's derivatives platform to work out how to wall off the technology platforms and workforce dedicated to the product, how to satisfy separate capital requirements and how to account for these new legal entities in financial statements.

The new capital requirements that firms will be required to hold against derivative products will make derivatives an expensive business to be in for those that cannot undertake the volumes to make it profitable. Firms will need to work through strategies to industrialize and increase the volume of their derivatives business, act as agents for smaller players, or suffer the costs and scrutiny of undertaking niche or one-off complex deals where necessary to sustain business.

Ban on proprietary trading

Beyond what is necessary for their own risk management or customers' needs, and with the exception of US government, agency, state or municipal obligations, federally insured banking entities will be banned from proprietary trading for their own accounts. No bank can become larger than 10 percent of the total liabilities of all US banks and they must also restrict their own investment in hedge funds and private equity funds to 3 percent of Tier I capital. This will need to occur within two years of implementation of the new rule, with an extension of up to five years for those firms trading in the most illiquid assets.

Given this timetable, we think that firms should have a three-year plan for how they will either divest their proprietary trading businesses or wind them down. There are key strategic decisions that need to be considered. Should proprietary trading be spun off, along with swaps trading, into a separate broker-dealer business, or sold to a hedge fund, retail brokerage or overseas bank that is not subject to the new regulations? How will it affect the risk profile of the business, and associated compensation practices, if highly paid trading and support jobs are eliminated?

Firms also need to look at how big the resulting revenue hole will be and how they intend to plug it. The largest trading banks will take the biggest revenue hit, but can they mitigate this by expanding private equity and hedge fund investing on behalf of their clients? How much hedging of operational risks will firms be able to do in relation to their client business?

Protecting against systemic risk

Now that the new Financial Stability Oversight Council can require systemically important non-bank financial companies and bank holding companies to end certain activities or wind them down altogether if they pose a threat to financial stability, firms with over $50 billion in assets must make plans for their own orderly wind down, or funeral plan. Those that do not manage to produce this will be subject to higher capital requirements, restrictions on growth and potentially divestments, so the incentive to get this right is high.

This undoubtedly will be an onerous process, particularly for the largest and most complicated organizations, which will involve trawling through every part of a business, so it should be connected to other initiatives to make the overall impact to the company less expensive. Firms should make this funeral plan pay double duty as an ongoing review of operations and an optimization plan, and while they are going through the process, eliminate any operational complexities that the company can live without.

As part of the increased industry monitoring, firms will also have to supply the council with more stress-tested data about the health of their businesses and disclose much more information about risk assets. Systemically important firms could also end up paying the government in the event that proceeds from the bankruptcy of one of their competitors, or clawbacks from creditors, do not cover liquidation costs, with the riskiest firms paying the largest assessments. Businesses will also need to look at how they will provision for this if another systemic failure on the scale of Lehman Brothers was to take place.

Enhanced capital requirements

The largest firms will have to increase their capital adequacy requirements to ensure that they can withstand future market challenges. In addition, bank holding companies will have to adhere to the same minimum leverage and risk-based capital requirements as bank subsidiaries, and those with $15 billion or more in assets will no longer be allowed to use trust preferred securities or other hybrids as Tier 1 Capital. Unless the Federal Reserve specifically exempts them, systemically important non-bank financial companies will also need to comply. Implementing regulations will be issued no longer than 18 months after the Act's effective date, although phase-in dates vary, depending on the type of institution.

Given that firms will need to hold back more capital, reduce leverage and, in some cases, raise more common equity, they will make less money per dollar of bank capital at a time when lucrative business lines such as proprietary trading are being wound down.

So not only will firms have to implement new capital planning and utilization processes, it makes it even more crucial that firms hunt for new business opportunities in the post-reform world. Companies could reap double the benefits if they enter new profitable businesses that can bolster return on equity while also fulfilling the need for more capital. This is why capital markets firms will likely increase their push into retail banking, placing greater pressure on mid-market players to remain viable and competitive in the new market landscape.

Compensation practices

The new regulations mean that shareholders must now hold a non-binding vote on a company's executive pay and golden parachutes every two to three years and listed companies must also appoint independent compensation committees. Financial institutions will also need to show how compensation practices relate to their stock performance and federal regulators will be required to issue and enforce joint compensation rules for federally regulated companies.

Firms will need to implement new compensation rules and revisit performance management, training and retention processes. If firms can no longer pay their very top people to take large risks, and talent follows the money, will firms be able to run their organizations with a broader range of senior people, rather than an elite few? If firms exit or spin off proprietary trading or swaps trading, removing the need for the highest paid traders, how does that affect the relationship between the risk a company takes and the compensation it pays out?

A new Consumer Financial Protection Bureau

The new Consumer Financial Protection Bureau, housed within the Federal Reserve, will regulate the provision of consumer products such as mortgages and credit cards by financial services companies with over $10 billion in assets.

This will require firms to revisit their product fulfillment and servicing processes and workflows. For example, putting together the data attributes needed to meet the requirements of the Consumer Financial Protection Bureau to track the fees charged to customers and the transactions they have executed will be a weighty task. Rather than spending millions of dollars creating a discreet database that has no other value, we believe that firms should build this useful data on customer activity into their Customer Relationship Management system, so they have a real opportunity to enhance their customer-centric businesses and, armed with new information, come up with new product ideas.

We can see from the above that, while looking at each area of reform in isolation presents a baffling array of moving parts, looking at how the different provisions fit together and how they can influence other parts of the business offers much more clarity on the impact to the whole company.

Conclusion

As we have seen, The Dodd-Frank Act has many interrelated implications for how all financial services firms will run their businesses, both short-term and long-term, and as a result, the financial services industry could look very different in five years time.

The Act will increase costs, potentially hurt profits, produce new operational challenges and pose significant strategic questions about how firms will prop up their return on equity while absorbing the cost of more reporting to regulators, a more expensive cost of capital and the loss of some of their most profitable businesses. The most nimble and efficient banks, insurers and broker-dealers could pick up market share at the expense of their larger, less efficient competitors, which makes it crucial that firms make an efficient strategy for implementing reform part of the DNA of their businesses.

That is why we recommend that clients tackle these reforms by taking a holistic look at their companies, developing a master plan and making one set of business, technology and data changes across the enterprise. Companies that do this will have the critical insight and the competitive platform they need to stay one step ahead in the new financial landscape.

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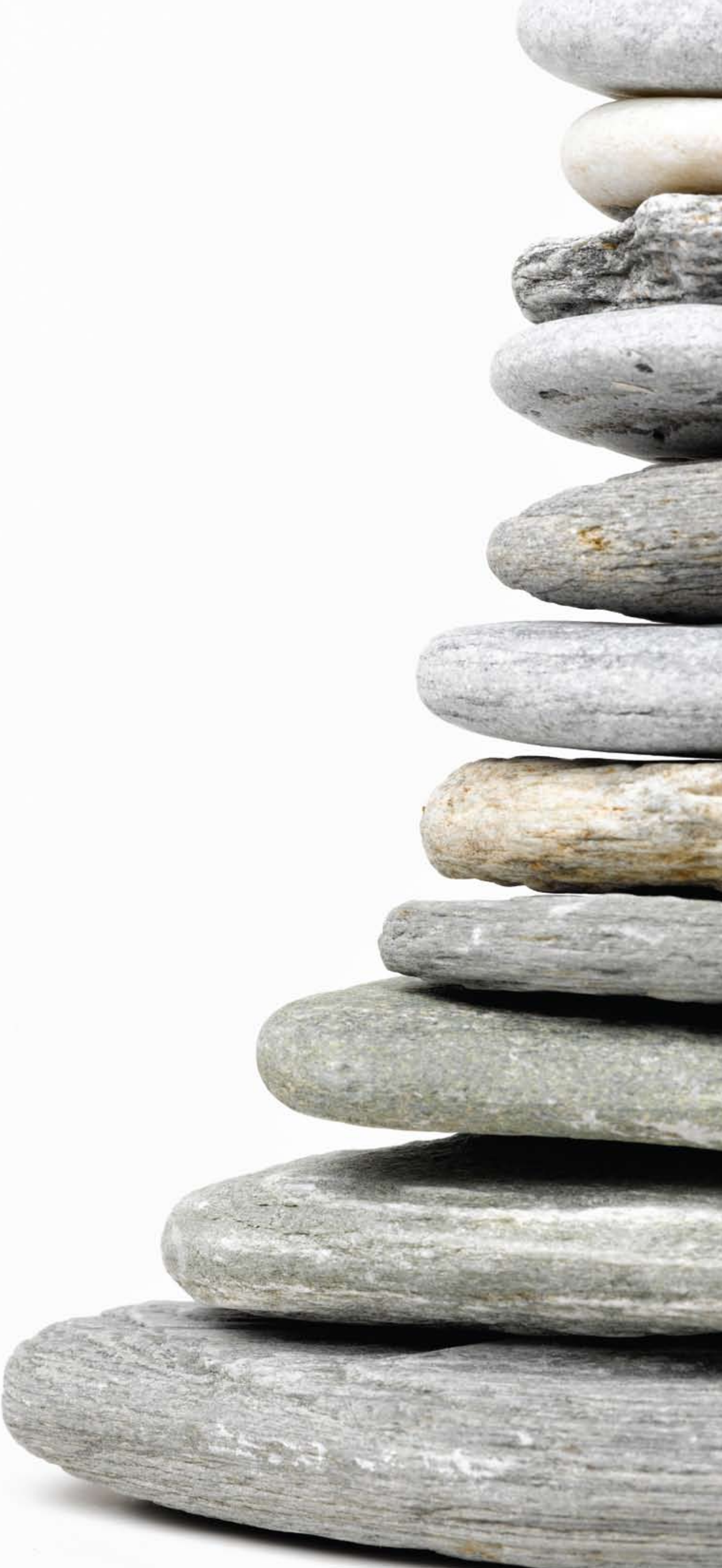

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