Hard to Do, But Worth the Effort:
How FBOs Can Still Do Well In the U.S.

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The policy climate in the U.S. has dimmed the enthusiasm many foreign banks have long had for a sizeable presence in the U.S. financial system. Following today as I do Comptroller Curry and FDIC Vice Chair Hoenig in addressing you, we are all now even more chastened. The new climate of heightened risk-management and governance expectations, stringent resolution standards, and demanding prudential rules sets the bar very, very high. I have been among the first to criticize many of the new rules – a 2012 paper from my firm was, I believe, the first to call attention to their cumulative impact and resulting unintended consequences http://bit.ly/1BHgpP1. But, not only are many of the rules warranted, more than a few of them are also needed and very few of them are going away. Thus, the key to success in the U.S. is to reckon with the new policy framework, reflect it in your strategic planning, define your comparative advantage and then to go for it.

My thinking owes much to my interaction with many of you here today. After my talk to you last year, several of you asked me to lay out specific issues for the Institute and your banks, and my staff and I very much enjoyed talking further with the IIB board in 2014. Since then, several of you have made great strides in redirecting your U.S. strategy, doing so in concert with continuing efforts to construct comprehensive compliance programs.

However, new challenges and new opportunities have arisen since we last spoke, and I will this afternoon lay these out and provide my latest thinking on successful strategic planning and corporate development in the United States.

Of course, our time is limited today and I would like to leave room for us to talk together during the Q&A. Let me thus quickly summarize the lessons we have learned in our practice in this area and its application to foreign banks doing business in the U.S.:

- FBOs must have a clear mission set by the parent that realistically anticipates the U.S. policy, enforcement, and market framework. You might wish all this legal and reputational risk will just go away, but it won't. Worse, under-estimating legal and rep risk can quickly create overall franchise risk. Even so, though, these risks need not define strategy – if all you do is hunker down, critical opportunities will pass you by.

- Because policy drivers are the most critical differentiators of success in the wake of the financial crisis, the FBO must map its business plans against both its parent's objectives and a forward-looking analysis of the U.S. legislative, regulatory, and policy framework. Because of the blizzard of new rules, many banks have been focused first on advocacy and then on compliance, doing so rule-by-rule in separate decision-making groups. However, rules have cumulative, cross-product impact and it's critical thus not only to go beyond comment and compliance – important though this is – to forward-looking planning on a cumulative-impact basis.

- This is even more vital in the U.S., where non-banks can and do compete head-on in even the most traditional products. The market is the same for all players, but policy drives each differently. Knowing this determines real, forward-looking comparative advantage, permitting effective resource allocation and corporate development.[1]

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[1] My recent column in the American Banker lays this issue out in more detail on a business-line basis.

Critical Policy Drivers

I will go into depth on each of these points in a moment, but we have a lot more information on all of these on my firm's website www.FedFin.com and I would be happy also to take questions on them. However, let me first put them into the policy context that is critical at each of these strategic steps.

The 2015 line-up of critical policy drivers for your strategic decisions in the U.S. include but are far from limited to:

- **Funding**: All FBOs – but most importantly those of you with U.S. retail operations – know that deposit growth drives franchise value. Now, deposit growth is challenged by the LCR and the NSFR, especially if liabilities come from penalized funding sources. The *de facto* ring-fencing demands made by the FRB in its new rule for FBOs also complicates the liability side of asset/liability management which, in concert with resolution and related drivers, is leading to a lot of subsidiarization, holding-company formation, and inter-affiliate transaction restrictions. MMFs will remain major competitors despite some possible SEC rule changes, and non-bank providers are also a looming presence in the U.S. TLAC also affects funding options for those of you affiliated with G-SIBs.

- **Assets**: Liabilities of course have to go somewhere for there to be net interest revenue and somewhere now is complicated by all the new capital rules – leverage perhaps most importantly – and several other major policy drivers. Identifying assets from both a portfolio and securitization point of view that work in the new policy framework is another set of line-of-business decision drivers that require policy-driver maps.

- **Capital Markets**: Extraterritoriality remains a major policy driver here despite continuing efforts by global regulators to work something out. Another major issue is the effect of universal-margin rules in the broader liability and asset context, and these margin requirements must be considered also in the context of pending efforts to ensure that central counterparties are resilient under severe stress. If CCP resolution rests on initial margins and your default-fund contributions, major obstacles to bank participation in clearing-and-settlement activities with profound strategic consequences will ensue. Continuing questions about automatic stays in resolutions also put a lot of pressure on bank capital-market activities, especially in the U.S.

- **Asset Management**: This, along with wealth management, is an area with considerable potential in light of all the policy drivers mentioned above. It is not, though, without major policy questions all its own. In the U.S., the Financial Stability Oversight Council is carefully scrutinizing this business line. It will take time for it to act, but banks in both asset management and related activities (e.g., custody, securities financing) will face a near-term challenge as the FRB looks at intra-group risks.

- **De-Risking**: Global and U.S. regulators have realized something you all know well – the legal and reputational cost of AML and related compliance has grown to the point at which banks are simply refusing to do business with certain customers. Regulators are, as a result, now urging you to do what I call re-risk – that is, reach out and hug a customer who might otherwise look problematic. Of course, if you guess wrong, you're back in the frying pan. Thus, from a pragmatic perspective, I believe policy drivers will continue to require de – not re – risking.

I hear a lot also about governance challenges, particularly with regard to naming independent risk managers and restructuring FBO boards. Ensuring improved risk aggregation, documentation, and internal audit is of course another top priority. These add cost to your U.S. operations, as well as raise legal and reputational risk. However, from a forward-looking strategic perspective, I suggest taking them as a given. Build-out must continue, but planning should be premised on these requirements and then move on to action.

One final thought on the policy framework: it has increasing potential to strike at the heart of diversified banking organizations, demanding not just internal inter-affiliate transaction restrictions, but now also high firewalls or even flat-out divestiture. Some of this pressure comes in resolution planning, some from rules particularly potent for FBOs. Much, though, now also comes from investors and analysts asking fundamental questions about the synergies that banks have long believed core to their franchise value. If you believe customers value cross-selling and that integrated product offerings promote real return without adding risk, this message must be quickly, analytically, and credibly advanced to an array of opinion-leaders who drive policy action not just in the U.S., but also in your home countries.

Charting a Path to Success

With this brief tour of policy drivers, let me return to the FBO to-do list and suggest some near-term actions to enhance your franchise.

Many FBOs have split goals in their U.S. operations, cognitive dissonance made all the louder by recent policy developments. Some FBOs are content, especially in the wake of the crisis, to constrain their efforts here to serving parent-company needs, essentially providing dollar-clearing services and getting as many pieces of other people's deals as possible.

But, often this reduced role is not truly satisfactory, with the parent company also harboring ambitions for a larger U.S. presence based on growth prospects in the U.S. versus those around the world, the innovativeness of this market, and the need to realize return from prior investments here.

Lesson one from our work over the past year or so is, thus, to know what's really wanted from the U.S. operation over the next three to five years. The worst result I know is for the U.S. operation's head to assume he or she is here largely to keep the lights on and then to find out that the U.S. is seen back home as a bright light in an otherwise dark competitive landscape. Forced to scramble, bad deals get done, operational corners are cut, and the whipsawed U.S. bank struggles even harder to achieve its goals.

This market is demanding not just in terms of competition, but also in terms of the regulatory climate. You thus need a strong policy infrastructure to ensure successful business development, infrastructure you shouldn't think can be retrofitted when someone back home wants rapid franchise realignment here to support flagging home-country operations.

Of course, the interaction with your parent creates not only downstreamed demands from headquarters, but upstreamed opportunities for your operations to show just what it can do and how this contributes to the goals your parent bank is being forced to redefine due to all the policy drivers restructuring its future franchise value. To understand U.S. potential, we recommend laying out current

business lines and those identified by the parent as of interest in concert with your own analysis of how to build on what you do best.

This map of products and services should then be assessed based on U.S. policy drivers. Non-policy considerations like interest rates, macroeconomic growth, and the like drive the business, but no matter how promising these profit drivers are, they won't give you an edge if the policy ones undermine your comparative advantage against current or likely competitors – non-banks again especially included in the U.S. context.

Lesson two thus is to undertake a disciplined, objective, and forward-looking map of policy drivers on a line-of-business basis. We have found that one important benefit of this is identification of correlation factors. Because of the blizzard of new policy requirements, many banks have been focused on each of them first from a comment and now from a compliance perspective. However, we have seen that policy drivers on one side of the bank or of the balance sheet reverberate in other, often unexpected ways that can create not just risk, but a surprisingly robust number of new opportunities.

Conclusion

We all talk a great deal about what the financial crisis taught us about systemic hazards and the enormous vulnerability at which they put day-to-day prosperity. However, there's another enduring lesson management should take particularly to heart: Always a regulated business, banking is now governed top to bottom not only by market forces, but also by governmental decisions. Some may seem arbitrary, many are contradictory, and most radically change each bank's profit engine.

All of them all together do one more thing: they mean that management cannot just plan for the radical disrupters reshaping technology, millennial decision-making, and product choice across the financial system. Policy decisions drive profitability at banks at least as much as all these forces. Indeed, policy drivers are a still more important force because they differentiate banks from all of their competitors and further divide banks in one country from those in another in terms of the basic cost of doing business.

In the past, senior management has had the luxury of delegating decision-making on policy drivers to counsel, compliance officers, and other specialists. No more. No more for the industry as a whole and no more especially for all of you, caught as you are in the midst of sweeping change in the U.S. that sometimes conflicts with all of the reforms redefining your parent companies.

It's easy to hunker down, keep to business as once it was, and try to out-compete on the basis of price or risk-tolerance, not careful analytics that spot emerging opportunities and dodge coming risk. But, the easy course is, I fear, the losing one. Banking is changing very, very fast, with the forces redefining the industry at gale force in the U.S. because non-banks hold such sway in so many critical sectors. This is, though, a prosperous, promising market – laying out new strategies in this changing framework thus offers real opportunity for banking that is not just prudent, but also profitable.