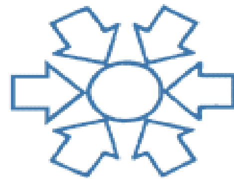
# Banking in the U.S. for Profit Even If It's Not Fun Anymore:

# The New Strategic Landscape for Foreign Banks

**Karen Shaw Petrou**
**Managing Partner**
**Federal Financial Analytics, Inc.**



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- The U. S. is too large, strong, and innovative a financial market for a bank to exit simply because the new rules look hard and costly. They are hard and costly, but they're done. This forces strategic choices that can in fact prove very successful.

- The U.S. is a critical market because its vitality can offset stagnation at home, its innovation leads the way into new retail and capital-markets products, and even its regulatory framework – hard and costly though it is – is what it will take to compete world-wide in any best-practice regime. Subsidiaries aren't as bad as feared if properly constructed, while non-traditional activities pose significant opportunities.

- Maximizing profit is not regulatory arbitrage when it results from identifying activities in which the new capital and liquidity rules do not undermine economic assumptions – and there are lots of them.

- The first priority for all FBOs, especially large ones, is to craft an implementation plan. The FRB may ask for this as soon as June, 2014 and you need to be ready not just for this, but also for rapid action to achieve first-mover advantage

It is a pleasure again to join this group of top global bankers – your annual Washington meeting brings in the most senior U.S. decision-makers and helps to set policy on the critical issues that increasingly define day-to-day banking around the world. Sally, you've done it again with a line-up I am honored to join.

I know you all fought hard on the Federal Reserve's new rule for foreign banking organizations (FBOs) and have already gone through the new standards in detail. So, I today won't revisit the policy pros and cons of the rule – what's done is done. Nor will I walk through key provisions in the measure, as each of you is deep into the details for your U.S. operations to figure out what you need to do how by when. Instead, I'll talk through ways to take what I know many of you think is a great big lemon to lay out some ways to turn it into lemonade.

Let me be clear, I am not talking about ways to evade the new rules. That is not only illegal, but also not so bright. Lawyers may advise that fancy footwork is technically legal and they may well be technically right when they do. Supervisors may even tolerate complex structures for a while either because they don't understand them or because they can be convinced that something cute is also something legal. But, your competitors won't take the same charitable view and, in time, they will make their concerns known to the FRB and – and if they're not just mad at you, but also good at public influence – they may well also leak a few stories about how XYZ Bank has evaded the FRB. As the FBO rule demonstrates, when the Fed gets angry, it gets even.

What I am talking about is harder than finding a few ambiguous passages in a complex rule. Instead, it's matching up your strategic vision of providing financial services in the U.S. with the new policy landscape. Because this landscape is both complex and incomplete, strategic-mapping analytics cannot continue as before. You can't do as many banks have over the years, looking at a possible transaction in the rulebook to count its capital costs and other conditions and then make a go/no-go decision. This is what I would call "silo" planning akin to silo rulemaking – that is, one deal is assessed in terms of the

rules that immediately apply to it, not in the context of prospective rules and their sum-total impact on the financial market. When one business line is pushed out of the banking system due to uneconomic regulatory cost, it lands somewhere if the market still wants it. Is this an activity you still can do, but in a new way through, for example, serving your clients instead of doing it yourself? Are their pockets of profit -- significant ones – resulting from enabling transactions by others instead of engaging in traditional financial intermediation? What about adding some low-risk, traditional activities to your mix to make the capital rules make sense?

Forward-looking planning now requires forecasts of how both wholesale and retail financial services will be configured over the next five to ten years, looking both at banks and "shadow" firms to understand who is best advantaged where on each business line core to your planning and that of your parent company. A recent transaction pointing to this new direction is BBVA Compass's decision to acquire Simple, positioning it in the merging retail-payment stream in the U. S. in an innovative way fully compatible with the new regulatory reality. RBC has led the way with covered bonds developing a new mortgage securitization channel in the U.S. based on its back-home expertise. And, of course, several very large FBOs have long, profitable experience offering full-scope retail banking in the U.S.

It will take time, of course, to know if any single transaction rings the winning bell, but this type of innovation is in my view key to success in the U.S. precisely because the entire array of banking and financial-services products is reshaping itself so fast.

So, how to build this strategic map across a new regulatory roadway marked by stop-signs? I'll try not to sound like the lady in your automobile's GPS and now outline a few paths I've learned in our work in this area:

- Think fast even as you implement with care through all the new-product approval and related requirements. The FRB has delayed a few deadlines in the FBO rule, but that doesn't mean it isn't planning to demand fast answers about your U.S. operations or, for the biggest among you, soon to subject them to stringent stress tests. If business lines are no longer viable, the sooner you know, the better you can divest or restructure without paying fire-sale discounts. If new ventures are appealing, the sooner you can offer them, the better the margin. From a case-history perspective, the most successful U.S. banks year-in, year-out are those that master their innate compliance cultures also to innovate ahead of the pack.

- The new capital rules for FBOs, especially those with significant broker-dealer operations, are daunting. But, a lot of U.S. BHCs are doing nicely under them, especially if one calculates earnings without legacy loan losses and litigation and anticipate higher short-term rates in the next year or so. If they can do it, you can do it too, often without downstream capital from any of your hard-pressed parent companies.

- Diversification can make the leverage capital standards as economic as possible, and I have found that thinking about products or business lines that sit in the sweet spot between the leverage and risk-based rules can be very productive. Forced out of securities financing? Maybe, but what about asset management? Or, do low-risk, high-volume capital markets activities still make sense if leavened with lower-volume, higher-margin operations that make the capital numbers come out right on the bottom line? A comprehensive look at capital and liquidity is required now since many long-standing activities look awful if viewed solely on their own in the new, harsh light.

Think carefully through the pros and cons of subsidiarization. Branching was often best before, but that may well not be the case anymore. I know that subsidiarization means restructuring to be more U.S.-focused, for example by bringing in more independent directors and risk-management capability. However, this isn't all bad – you'll know the U.S. better after getting all this on board and a sub – particularly if you are looking at traditional banking services – gives you a lot of market power.

- Consider financial intermediation in the U.S. not just from a traditional perspective, but also by taking into account how non-bank financial companies are and will engage in key retail and wholesale activities. One thing I've seen a lot of of late is banks – U.S. and foreign – reading the rules, counting the cost, and dropping otherwise-profitable operations. But, new competition can mean not just new problems, but also significant opportunities. Specialized activities made uneconomic by new rules can be transferred to clients without doing franchise damage. In short, if you can't beat them, join them and profit thereby.

Is it good policy for business lines – again I'll mention securities financing – to be forced from banks into the "shadows" due to these new rules? I don't think so and, indeed, I know a lot of regulators who don't think so either. But, these regulatory drivers forcing many activities out of banks into different types of non-banking institutions – hedge funds, private-equity firms, insurance companies, technology giants – are what they are at least for now. The advocacy all of you do will, I hope, right the balance between banks and non-banks so that customers are better protected and new sources of systemic risk are corrected before they grow dangerous.

But, as senior managers in the U.S., you've a job to do. Some of it is to encourage constructive public policy here and back home to make finance safer and better. Some of it is to do your best to promote your bank and earn a reasonable, prudent rate of return in your U.S. operations. If the rules say you can't do something profitably but one of your clients asks for services to facilitate its operations in this sector, it's worth thinking through whether this is a venture worth pursuing. I'm not arguing for facilitating undue risk-taking by non-banks – say by securitizing high-risk loans in hopes they're off your books before bad things happen. I am talking about looking at providing maturity and liquidity transformation services made uneconomic by bank rules to non-banks through innovative advisory, marketing, and structuring services – all of which remain not just legal under the new rules, but also safe and sound. At the same time, traditional financial intermediation remains important. Are there deposit-taking or lending activities in the U.S. that build on your parent's expertise?

Let me say in closing that I have found that the most successful U.S. banks are those that marry effective policy advocacy with the ability to anticipate new standards to restructure profitably before being forced to do so at cost. This isn't a compliance or legal exercise, critical though it is to know what can be done and how one is allowed to do it. Instead, it's a top-level strategic plan that recognizes the company's risk tolerance, understands parent expectations, adheres to strict governance standards, and still develops new products, restructures old ones in new ways, and builds the U.S. bank into a best-practice, forward-looking venture.

The Federal Reserve has laid down a gauntlet to foreign banks doing business here. My recommendation: pick it up not to smack the FRB – it won't notice or much care. Instead, pick it up to wear as part of a new outfit in the U.S. that anticipates emerging financial-market trends, finds targets of opportunity, and develops these quickly to profit both your U.S. operations and your parent banking organization.