The How-To of What-If:

Counting the Capital Cost of the New Regulatory Landscape

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On our panel today, you have heard Gov. Pawlenty discuss his worries about new rules and others arguing they don't go anywhere near far enough. I look forward to adding my voice to this vital debate shortly, but want to address my formal remarks to another critical question: how to plan for the strategic impact of all of these game-changing policy developments. Whether rules are right or wrong from a long-term financial stability perspective is the key point for advocacy and policy decision-making. But, regardless of what's right and wrong, management cannot defer forward-looking, objective analytics on what these rules – even those still in draft form – mean in terms of capital adequacy and competitiveness.

All too often, the strategic consequences of regulatory and legislative action are not carefully considered until all the shouting is over. Lawyers are trained to look into the rulebook and sometimes have difficulty advising clients until they can read something in final form. Forecasting the final shape of legislation is of course even trickier, since to say that Congress and global legislators do not act in due, deliberate course is to understate the chaos that ordinarily cloaks their divisions. But, waiting for finality has two high-risk consequences:

- First, your bank could flunk the FRB's tough new stress test. I'll get to why in a moment, but it's critical to recognize that the Federal Reserve has added policy analytics to all the others the board and senior management must approve as part of a successful capital-distribution plan.
- Second, forward-looking policy analytics demonstrate the value-added of legal, government-relations, and risk-management planning. A bank that accurately forecasts policy action wins first-mover advantage – a vital edge as ROE comes under increasingly acute strain. Again, I'll lay this out in more detail in a moment.

Others on this panel may disagree on whether new rules are right or wrong, but I think we all come together on one thing: most of the new standards are game-changers. Take, for example, the leverage requirements. One major industry group has measured the pending U.S. and global leverage-capital rules as costing twelve very large banks $202 billion in new capital or forcing a reduction of $3.7 trillion in assets[1]. This is no joke – even if the numbers are off, they aren't off by so much that the strategic impact of the new capital rules doesn't redefine affected banks.

[1] The Clearing House Association, *Assessing the Supplementary Leverage Ratio,* September 23, 2013, *available at:* http://www.theclearinghouse.org/index.html?f=075291

Your BHC may be smaller or even relish the thought of all the pain exacted on the largest banks, but the redefined banking system the standards would create are as much of an analytical challenge to you as they are to the very largest BHCs. So, before returning to policy rights and wrongs, let me lay out a how-to guide for you, your senior management and board to the new requirements for reputational, strategic, and compliance risk governance and capital planning.

FRB Requirements

On August 19, the Federal Reserve Board issued its supervisory expectations for capital planning at large bank holding companies. The statement makes it clear that BHCs and other firms subject to Federal Reserve Stress tests will need quickly and, for the most part, dramatically to improve practice to ensure that capital distributions can proceed as desired in 2014. Importantly, the FRB now stipulates that:

> "Given the scope of operations at and the associated breadth of risks facing large, complex BHCs—including the risk of losses from exposures and of reduced revenue generation—they are often exposed to risks, other than credit or market risk, that are either difficult to quantify or not directly attributable to any of the specific integrated firm-wide scenarios that are evaluated as part of the BHC's scenario-based stress testing (other risks). Examples of these other risks include reputational risk, strategic risk, and compliance risk."[2]

After detailing these added risks, the FRB stipulates how each is to be incorporated into satisfactory capital plans. Critical to meeting this requirement is providing the board with scenarios that stress core assumptions and reflect independent risk assessments supported by expert judgment, with the supervisory statement making clear that a best practice is the use of internal models supported by expert judgment.[3]

The FRB also makes it clear that the results of risk analytics for reputational, strategic and compliance risk need not necessarily lead to higher capital – indeed, the statement stipulates that simply adding a percentage of additional capital as a buffer above minimums is a poor

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[2] FRB, *Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice*, Page 6 (Aug. 2013), *available at*: http://www.federalreserve.gov/bankinforeg/bcreg20130819a1.pdf.

[3] Ibid, Page 17.

practice likely to be sanctioned by the FRB. Capital may be a required response, but so too could be reduced revenue scenarios, higher loss expectations, and/or a management "overlay" that adjusts expectations in a targeted fashion.

In short, the FRB is looking for thoughtful, forward-looking governance of qualitative risk, now making it clear that BHCs that flunk this tough test will join those barred from making planned capital distributions. As you all know well, the market doesn't take this kindly.

How Not Just to Comply, But Also Win

The best way to meet the Board's new demands is to craft a disciplined, forward-looking, objective assessment of reputational, strategic, and compliance risks by business line. A guide to how to do this is on my firm's website, and it's not as hard as I suspect you think. The most critical aspect of forward-looking policy-risk analytics is forecasting likely outcomes of critical rules like the new leverage-capital standards, the orderly-liquidation requirements, pending limits on short-term debt and the like. And, one needs to do this not just on an enterprise-wide basis, but also to look at key business lines. For example, for mortgage finance, the policy-risk analytics need to assess the prospects for housing-finance reform and what this means from both a reputational and strategic perspective. Does your bank do student lending? Forward-looking planning here is essential, with at least one big bank judging risks too high for prospective reward. Corporate finance? If so, how do new syndicated-loan and leverage requirements hit? Securities financing is being rocked by new repo rules, and these too need careful analytics to ensure your bank is well positioned.

All of this sounds like it costs a lot and, like most good risk management, it won't be done well if it's done on the cheap. However, I think your banks have these resources already at hand – you wouldn't be at this conference if you weren't committed to a forward-looking knowledge base on which your company can base its reputational, strategic, and compliance risk. The results are dramatic.

- They protect the BHC from falling short of FRB expectations related to risks often not well quantified in existing models, reducing the risk of failing the stress tests and absorbing the hit to market capitalization and other costs that then ensue.

- They inform the board and senior management in a rigorous, disciplined way about emerging reputational, strategic, and compliance risks on an enterprise-wide basis. The complexity of these risks and their seemingly "political" nature have long obscured the bottom-line impact of these risks absent appropriate mitigation. They demonstrate the value-added of work done by risk management, compliance, legal and government relations that are often viewed solely as cost centers.

- They support forward-looking calculation of legal risk, essential to effective calculation of reserves highlighted by the FRB as a critical concern.

- They are a vital early warning to the board and senior management of emerging risks that, even if not yet evident in new rule or law, are gathering momentum and may well change the BHC's established business practices.