Fall 2015: Financial-Services Strategic Landscape

Key Policy Challenges and Effective Action

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The views expressed in this paper are solely those of Federal Financial Analytics, Inc. (FedFin). FedFin has counselled financial institutions – bank and non-bank, government agencies, and investors – since 1985 on policy drivers with strategic impact, doing so through both analytical and proprietary-advisory services. The firm's managing partner, Karen Shaw Petrou, has been called the "sharpest mind analyzing banking policy today- maybe ever." More information about the firm may be found at http://www.fedfin.com/.

How Market Turmoil Drives Regulatory Policy

Forecast

- Market uncertainties and volatility will reinforce regulatory incentives for event-driven actions aimed at easy targets, with heightened political pressure punishing any financial institution seen as a precipitating source of volatility or instability.
- Operational risks evident in recent market incidents will be quickly addressed through enforcement actions, new rules.
- Regulators and politicians will focus on systemic hot spots instead of understanding correlated risks across markets and financial activity/charters.
- Crises may expose vulnerabilities in recovery and resolution protocols, sparking renewed regulation and increasing requirements for the largest financial institutions to operate as utilities. U.S. legislation to repeal OLA will advance. If large-bank living wills are again disapproved, forced restructuring will begin.

Action

- Build a risk heat-map to identify vulnerabilities, reinforcing risk controls and revising strategic planning based on exogenous and endogenous drivers.
- Identify regulatory drivers of risk correlations within the company and across markets. Determine which actions mitigate risk correlations and develop effective analytical-advocacy tools to demonstrate that change does not "water down" requirements. Address internal risk correlations ASAP.
- Anticipate policy demands from recent operational failures.
- In light of recent market behavior and strategic concerns, consider pending trading-book capital rules, operational-risk capital charges, credit-valuation adjustment, universal-margin requirements, NSFR to identify needed changes prior to finalization, investor concerns.
- Address weaknesses in critical infrastructure (e.g., CCPs, HFT, payment systems) and recommend policy change, take internal risk-mitigation action.

Political-Risk Environment

Forecast

- Continuing calls for breaking up big banks, repealing OLA, other sanctions in U.S. election campaigns
- Increasing enforcement sanctions (e.g., denied waivers, higher cost, less reliance on independent monitoring) in new settlements
- Heightened pressure on the FRB regardless of whether it tightens, loosens, or leaves unchanged its monetary policy
- Congressional battles begin in earnest over Dodd-Frank legislation, putting pressure on regulators even though final legislative agreement is unlikely in the absence of a market crisis (which would reshape pending bills into far more stringent and punitive form)
- G-20 meetings result in little meaningful agreement on pending financial-policy initiatives, increasing fragmentation and potential ring-fencing

Action

- Refine political advocacy to reflect public-policy priorities
- Identify key FRB vulnerabilities (e.g., threats to emergency-liquidity powers) to develop policy-based advocacy initiatives
- Determine desired framework for pending enforcement actions in light of new, far more difficult environments, moving beyond legal defenses to broader franchise-defense initiatives

Financial-Market Reconfiguration

Forecast

- Bank strategies premised principally on cost-cutting will come under acute pressure due to diminished opportunities, higher reserves, tougher stress tests, investor impatience.
- Earnings pressure and operational-risk remediation will constrain bank innovativeness. New-product governance rules and social-policy requirements also slow bank entry.
- OCC will encourage innovative national-bank charter applications, most likely to come from neo-banks, but reduction in available venture capital will constrain new entrants. Established neo-banks will expand.
- Digital-processing systems will advance, confronting significant market interest and sizable regulatory/policy hurdles.
- CFPB regulations advantage banks in prepaid cards and other retail-delivery channels if products can absorb added cost.
- Basel finalizes standardized floors, trading-book capital rules. Pressure grows for interest-rate risk capital standards, heightened risk weight for sovereign obligations.
- FRB will issue TLAC, NSFR, commodity proposals, finalize single-counterparty credit limits.

Action

- Identify new technologies where rules provide comparative advantage or do not unduly constrain entry
- Build internal policy platforms to support new initiatives, doing so well in advance of final offerings to ensure rapid adoption, regulatory compliance
- Identify policy actions that curtail competitors advantaged principally due to less-burdensome regulation and advance relevant policy action
- Determine analytics necessary to advance objectives on pending FRB regulation

Activity-and-Practice Regulation

Forecast

- Global regulators will identify activities, resolution obstacles for large asset managers based on product offerings (e.g., leveraged investment companies, hedge funds and risk correlations). Global resolution protocols will be built out and implemented by national regulators in widely-different ways.
- G-SII designations will not be withdrawn, but focus will turn to capital, intra-group, and resolution controls. Global resolution protocols will be built out and implemented by national regulators in widely-different ways.
- FSOC will identify problematic U.S. insurance activities and practices to pressure state regulatory action. FRB will propose initial capital framework.
- Treasury, FRB will determine need for activity-and-practice regulation for HFT, related market trading. Each will act under its authority and FSOC will intervene to press SEC, CFTC. CFTC will build out operational-risk infrastructure.
- Treasury will formulate policy on marketplace lending, blockchain processing, and other market innovations.

Action

- Identify asset-management, insurance targets of opportunity/risk
- Develop advocacy analytics to advance desired action, validate systemic and market benefits of a proposed course of action, reducing current advocacy focus on business-model implications
- Identify rapid recovery-and-resolution obstacles and develop recommended policy responses in key domiciles
- Identify market-liquidity drivers, operational risks related to HFT and develop analytics, advocacy to achieve desired objective

FEDFIN SERVICES

Federal Financial Analytics offers a suite of analytical services used by financial-services institutions around the world, investors, industry vendors, and global regulators and central banks. A simple retainer arrangement selected by many of these clients provides:

- daily alerts (often several in the course of a day) on key policy developments around the world and on the policy ramifications of changing markets;
- in-depth analyses of complex rules (e.g., all of the Basel capital rules, the FRB's surcharge standards, international resolution protocols for asset managers, broker-dealers, and insurance companies);
- in-depth analyses of major Congressional hearings and U.S. and regulatory actions;
- a weekly wrap-up; and
- a weekly memorandum from FedFin's managing partner Karen Petrou presenting her views on market trends and policy developments.

FedFin also provides a service focused specifically on U.S. mortgage finance, *GSE Activity Reports*. This service was among the first to anticipate the GSEs' failure in 2008, to identify emerging problems at the Federal Home Loan Banks, and more recently to identify current market drivers determining the success of growing efforts to restructure Fannie Mae and Freddie Mac through new risk-sharing transaction structures. The role of the Federal Housing Administration, private mortgage insurance, and the regulatory drivers for mortgage-loan origination are also tackled on an ongoing basis.

The services described above are generally available and do not contain proprietary analytics focused on specific business and investment decisions. FedFin's proprietary-advisory practice does so for financial-services firms, hedge funds, private-equity investors, and new entrants into the financial sector. Recent proprietary projects have included:

- line-of-business analytics for major financial-services institutions (including U.S. GSIBs) in which FedFin laid out the policy-driver landscape for critical operations, identifying forward-looking comparative risks and advantages;
- analysis of acquisition targets to identify franchise-value drivers in the regulatory, legislative, and political environment;
- development of alternative financial-service delivery models designed to capture forward-looking policy advantages;
- advice to central banks on U.S. policy factors that influence monetary policy, supervision of foreign financial institutions in the U.S., and financial stability;
- analysis for major regulatory agencies on market factors that affect their policy and supervisory actions;
- policy analyses issued to opinion-leaders by the firm that are funded by clients but reflect FedFin editorial and methodological conclusions. These papers address major policy decisions and provide third-party quantitative and qualitative analyses that promote constructive, near-term action; and
- ongoing client advice on matters related to policy analytics and advocacy. This service is provided via an annual retainer to ensure ready access to FedFin analysts and management for comment-letter review, regulatory-relationship counsel, early alerts to emerging risks and opportunities, and participation in board and senior-management deliberations.