REGULATORY REFORM: THE NEW BIG SQUEEZE!

Key actions financial firms can take in the wake of new legislation

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Risk management gets viral: Should consumers use protection?

Beyond the multifaceted impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act, ensuing regulations will prompt financial firms to adjust to the new risk management landscape. The regulatory reform will squeeze margins and may strain capital adequacy. To grow profitably, financial firms must improve the credit worthiness of consumer and commercial loans. Big firms already engulf most of the US market, and strengthening them could further polarize the competitive landscape.

Among other provisions, the legislation will establish a Bureau of Consumer Financial Protection. This agency will be a conduit to raise consumer concerns, prompt regulatory scrutiny of financial firms, and possibly lead to fines and penalties. The financial industry should expect tougher restrictions on customer rates, fees and charges, together with more stringent disclosure standards. Facing tighter accountability, financial firms will be challenged to explain the complexities and sophistication of financial instruments in terms that customers can understand. To restore credibility, financial information should be more clear, consistent and simple.

The Act orchestrates a multi-agency resolution authority process to intervene distressed "too big to fail" firms. It also reassures US taxpayers about putting an end to bail outs. Aiming at restoring confidence in the financial system, the Act includes provisions to protect investors. To thrive in the new reality, financial firms should:

1) Avoid excessive leverage, exposure or concentration.
2) Align credit and liquidity management with productive purposes.
3) Recalibrate their business mix, capital adequacy and financial analytics to mitigate systemic risk.

The Dodd-Frank Act: Will regulators rein in systemic risk?

The Act seeks to bring clarity between agencies, reconcile structural changes with existing laws and remove uncertainty. A Financial Stability Oversight Council will be formed with 10 voting members drawn from top financial authorities. It will become a pivotal point to curb systemic risk, and would address global interdependencies and coordinate stability initiatives with the G-20.

A key objective reads: "To apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets." The Council would make recommendations to the respective regulatory agencies to mitigate imbalances and forestall future financial crises. Next, the agencies should revisit existing rules and issue new ones to drive structural change.

Complex, leveraged, and risky financial instruments represent a clear and present danger. Excess liquidity of securitized instruments stokes market volatility, and pervasive financial automation (to include algorithmic and high-frequency trading) might trigger another crisis. Regulatory changes may bring unintended consequences and require extensive effort. Regulations should avoid hurting core financial functions that deliver vital financial services to productive businesses and individual customers. For example, the increased regulatory burden might curtail the extension of credit and hurt the economy. Financial firms must heed new regulations smartly by reconfiguring lines of business, and avoid passing on the extra cost to their products and services.

To exert resolution authority over a firm which poses systemic threats, the Council should get the firm's board invested, or engage the US courts. As markets interconnect globally and instantly, systemic distress could resemble a runaway race car. Firms might not survive a protracted consultation and legal process while exposures and imbalances build up to trillions of USD. The Council should then monitor trends closely and anticipate potential danger within (and possibly outside) the industry.

To cope with future complexity, regulatory agencies will need to beef up their analysis and inspection resources. Given the acceleration of financial transactions, the Council must drive a much needed modernization and development of timely systemic risk information. A new Office of Financial Research will support the Financial Stability Oversight Council. As this office develops tools for risk measurement and monitoring and standardizes data, financial firms may need to accommodate new information demands to monitor stress conditions and systemic risk (e.g., Citigroup has just named a senior leadership officer to manage regulatory changes mandated by the Act.)

Too big, too stale: How should risk management models tap innovation?

As firms put behind the uncertainty over financial regulation, their boards should remove other barriers to effective risk management. A 2010 survey, conducted globally by the Economist Intelligence Unit on behalf of SAS **(*)**, highlighted the following top barriers:

- Poor communication across departments
- Insufficient data
- Risk management function lacks authority
- Lack of confidence in existing risk management tools
- Inadequate real-time (intra-day) risk management

Financial firms must recalibrate their analytic models to better reflect likely distress in economic scenario and evolving market dynamics. Besides provisioning for continuing deterioration in credit quality, risk management models should include more predictive information. Granular segmentation of both consumer and corporate customers will reveal emerging behaviors. Firms should scrutinize the essence of the calculations, resolve conflicts and overlaps and revisit the soundness of the underlying business assumptions.

Risk managers must put in place the right models, validate the outcome using common sense, and tap a much broader, dynamic and granular base of information. A holistic view of customers and stakeholders should integrate internal data and novel forms of proliferating external electronic interactions.

Strategic opportunity: How should financial firms restore productive lending?

While consumers get to understand the limitations and unintended consequences of being “protected”, financial firms must seize the opportunity to improve risk management and price competitively. The regulatory reform will drive firms to find alternative sources of liquid capital and make up for reduced non-interest income. Capital burdens, global volatility and systemic risks will restrain the role of complex securities. Boards of Directors should take a reality check, and act upon the regulatory reform for the good of the real sector, the US economy and the wider global economy.

Financial resources are getting tighter and should be put to productive use. Firms should focus more on delivering or enabling fundamental banking services and avoid financial speculation. Improvements in risk management should release more lending capacity and spur economic growth. Both customers and credit portfolios will benefit, which will in turn help reduce delinquencies and credit costs.

(*) Note: The report “Rebuilding trust: Next steps for risk management in financial services” may be found at http://graphics.eiu.com/upload/eb/SAS_2010_Rebuilding_trust_WEB.pdf