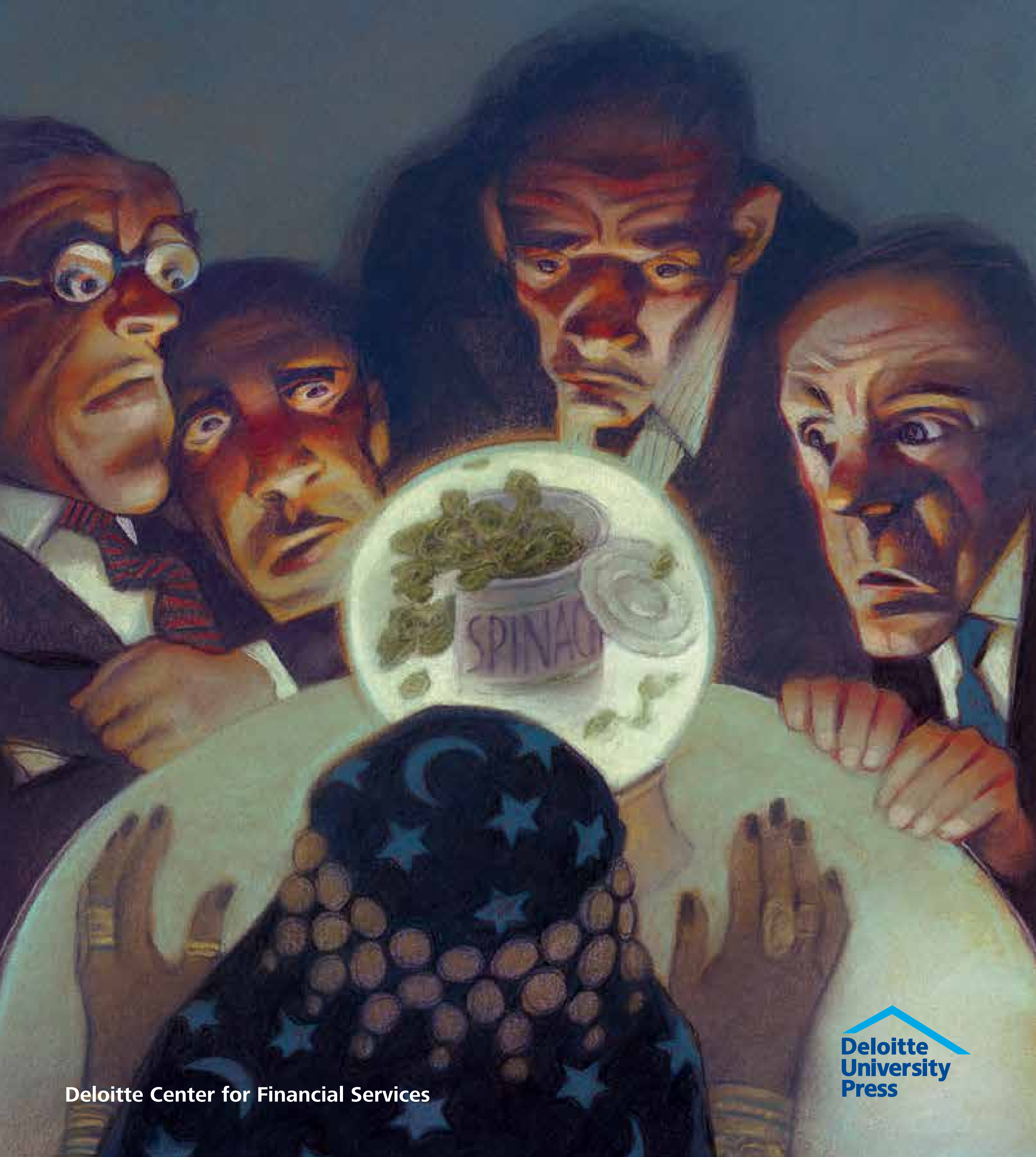
Future Tense

What two years of Dodd-Frank may tell banks about the future



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Introduction

WHEN the Dodd-Frank Act was enacted two years ago, many of the details were unclear, leading many industry observers to wonder what its true impact would be. In fact, some had hoped the Dodd-Frank storm would simply blow over. By now, it's clear that the principles embedded in Dodd-Frank are here to stay. While some adjustments may be made around the edges of this monumental law, the core principles targeting systemic risk are set: *financial stability* (through the creation of the Financial Stability Oversight Council, the orderly liquidation authority for systemically important financial institutions, and higher capital requirements) and *consumer protection* (evidenced by the addition of the Consumer Financial Protection Bureau). Big changes like those aren't likely to go away anytime soon—and they are expected to continue to have an outsized impact on risk management and compliance for banks.

While many in the industry already feel exhausted by the massive response the Dodd-Frank Act has required to date, in many ways we're just getting started. Those banks that can roll with the punches over the next few years, as these regulations continue to unfold, may be in a position to benefit. They have the potential to become more highly capitalized, strengthen their balance sheets, improve adaptability, and enhance liquidity. And they'll likely be operating in an industry that may be less tightly interconnected. Meanwhile, they are equally likely to face ever-increasing pressure to generate revenue, control costs, and achieve a larger return on equity—making such benefits that much more important.

While these regulations may be painful now, in many cases the resulting benefits are likely to be significant. For example, data quality and transparency are both areas where many banks have been looking to make strides for years. With Dodd-Frank, they have to make improvements—even if they must be made on a timeline that banks may not have tackled on their own. Timing aside, there may be benefits that can come from embracing (and maybe even surpassing) these new regulatory data and transparency expectations. And it's not just the issue of data in which banks stand to make serious gains on the back of Dodd-Frank regulations.

In this article, we'll quickly take stock of where Dodd-Frank has taken the industry to date, and then we'll look ahead to share some suggestions for banks looking for opportunities to turn this new regulatory environment to their advantage.

The new regulatory context

PERHAPS the most important observation to make about Dodd-Frank two years after its passing is that it is forcing banks and other financial institutions to effectively integrate business strategy with heavier regulations and government expectations. Before Dodd-Frank, strategic decisions on issues such as acquisitions, divestitures, product and customer management, and operations were frequently pursued before engaging the regulatory perspective. Banking organizations would often essentially work out the details before sharing them with regulators. While new regulatory regimes such as Basel II introduced new expectations, they were frequently handled separately from some of the strategic planning. In the wake of Dodd-Frank, regulatory concerns drive not only tactical, day-to-day decision making, but strategy-level decisions as well.

It also seems likely that Dodd-Frank is only the first in a series of similar regulatory developments that will likely have an outsized impact on the industry. For evidence of this trend, look no further than Basel III, which will be phased in over the coming years and is expected to fundamentally reshape expectations for capital and liquidity requirements, among other things. Financial institutions that don't take an aggressive approach to this new regulatory reality may risk getting left behind.

Exactly how these types of changes will disrupt the industry remains to be seen. It seems highly likely that banks will become less interdependent, for starters—a key goal of the legislation. It's also possible that institutions as a whole will adjust by becoming more strategically focused on certain business lines, while divesting others. Whatever is around the corner, we believe the four priorities that follow are the ones leaders should consider today to get their organizations prepared to lead into the future.

Become relentless about strategic efficiency

BETWEEN diminishing earnings, greater cost pressures, the need to maintain liquidity, and formal requirements to hold higher levels of capital under Dodd-Frank, there are plenty of reasons to improve the balance sheet. Most of the low-hanging fruit was picked years ago, so this goes well beyond simple cost-cutting. It demands strategic efficiency, which means asking some hard questions about the business itself. *Are we squeezing the maximum amount of value from our most profitable businesses? How can they be improved? Which businesses should we be getting out of? Should we invest more in low performers to achieve the desired results, or should we just move on? Should we acquire new lines of business? Which ones?* By analyzing different lines of business across the enterprise and then deciding whether to improve—or divest—lower-performing ones, banks can significantly improve their use of capital.

It's not as if banks have ignored strategic efficiency in the past. Some banks might not have survived this long if they hadn't made significant, fundamental improvements to capital efficiency already. But there's still a long way to go. Getting to the next level will likely require creatively redesigning their operating and business models to enhance internal efficiencies using tools such as global, regional, and local shared-services capabilities, outsourcing, near-sourcing, organizational simplification, re-engineered vendor management, and more.

A more efficient balance sheet and a more deliberate capital management program can play significant roles in this important exercise, particularly when it comes to determining exactly how much capital banks need to hold for each line of business. For example, whether a golf course loan is considered a real estate or operating loan will determine the capital requirement—and the amount may not be the same. With improved systems in place, banks can weigh cases like these in detail to make the most efficient use of capital. And that's just the start. Banks can use these systems to identify opportunities to create new customer products and services or acquire businesses that their competitors abandon because they can't make them work at scale.

HOW CAN BANKS ACHIEVE STRATEGIC EFFICIENCY?

- **Reassess the business portfolio.** Undertake a thorough, objective assessment of the viability of each business and sub business, given the greater capital and regulatory burdens. Examine ways to improve productivity—from both capital and operational perspectives—across your customer and product segments and locations.

- **Eliminate redundant legacy operations.** Embrace shared-service models to cut costs and help increase standardization. Make better use of new technologies such as cloud computing to lower costs through economies of scale.

Treat risk management as an investment rather than an expense

NO matter how well your business is performing today, without an advanced approach to risk management you have the potential to erase gains from any part of the business. The board and CEO should be informed by insights from everyone from front-line business managers to the chief compliance officer (CCO) and chief risk officer (CRO). All of these stakeholders should be considering how new business can potentially affect the company in the long run.

One of the ways they can measure this is through stress testing. Stress testing can help banks review their balance sheets, see possible outcomes, and change course accordingly. Right now, many banks view stress testing as a regulatory activity rather than as an advanced risk management exercise. But Dodd-Frank is formally raising the bar on risk management, creating an opportune moment for banks to look at this as an investment rather than an expense.

Consumer complaints are another area where there's a big potential advantage to going beyond mere compliance. As a result of the Consumer Financial Protection Bureau (CFPB), banks are now expected to keep a database of consumer complaints. What if banks approached the database not as a regulatory burden, but as a rich source of insights that could be used to improve the business? Identifying patterns within customer complaint data could help banks spot emerging problems before they disrupt the business, for instance, or improve the customer experience in more meaningful ways. Banks may see that a group of complaints in one area, such as a particular fee on a deposit account or a credit card, may also pose a similar concern in another area. The CFPB has also developed its own system to collect consumer complaints and will use it to identify problematic practices or products. In June 2012, the CFPB launched a searchable credit card complaint database that is available to the public. Banks that are slow to address complaints or fail to recognize, escalate, or even remediate problems may trail those that implement a more proactive approach.

HOW CAN BANKS SUCCESSFULLY EMBRACE RISK MANAGEMENT?

- **Raise the CCO's role.** Elevate the role, responsibility, and pay of the CCO.
- **Create stronger reporting mechanisms.** With a 24/7, enterprise-wide reporting platform, a CCO can anticipate, prioritize, and respond to new regulations as they are announced.
- **Make compliance more efficient.** Identify ways to speed up and simplify compliance by leveraging regulatory requirements from other major initiatives, such as the Foreign Account Tax Compliance Act (FATCA) and anti-money laundering/"know your customer" compliance.

Strong governance can also make a big difference during times of financial distress—a fact that has not gone unnoticed by regulators and analysts. As a result, there is now a heightened expectation that institutions invest more in their governance framework and processes to foster a culture that better manages and reduces risk. In the long run, this can help improve shareholder returns. In the past, some institutions may have taken a short-term view of increasing revenues while subjecting their organizations to greater risk along the way. Today, taking steps such as placing risk specialists on the board of directors, continuously monitoring and adjusting to risk, increasing accountability for risk across the enterprise, implementing an effective risk self-assessment program, improving communication among stakeholders, and proactively identifying and mitigating risk may drive more consistent earnings performance and generate more value across the board.

For many, improved governance is one important way to get more from compliance and risk management. Today we see many banks with independent teams working on different regulatory issues in vastly different ways, from vendor management to anti-money laundering legislation. It could be more efficient and effective to institute a centralized approach with visibility all the way to the C-suite and board level. This enterprise-wide regulatory "air traffic controller" can help manage, respond, oversee, and coordinate compliance and regulatory agendas.

With an integrated compliance and risk management function in place, it may be easier to forge important links between other functions such as marketing and vendor management, and create visibility to key individual executives such as the CFO, chief credit officer, and more. The result? Banks may be better prepared to prioritize their compliance and risk management efforts, rationalize and integrate their processes, and even anticipate rules ahead of time.

Wage the talent war

FINANCIAL institutions will have to cope with new incentive compensation schemes that they believe could drive some top talent to other industries, such as the technology or shadow banking sectors. Potential recruits may not be as interested in coming into the financial services field if they feel that incentive-based compensation programs driven by new regulations limit their earnings potential. Under these new rules, significant components of incentive compensation are required to be risk adjusted, or deferred, based on longer-term outcomes and balanced based on inherent risks. Additionally, financial institutions can use forfeitures during deferral periods to recover pay from employees who exposed firms to imprudent risks.

In the past, a large bank may have lured top recruits at universities by offering immediate and large incentive-based compensation packages that simply couldn't be matched by other industries. Today, some top recruits may think that these new deferred incentive compensation regulations impose a burden on their future earnings and long-term opportunities, which could lead them to consider alternative, more lucrative offers.

In this environment, banks may need to become more competitive in hiring and retaining talent. This may require using new approaches such as analytics to take a closer look at exactly what kind of talent banks are attracting and who they are losing. For example: *Do employees who are strongly aligned with professional or social networks perform differently than others? Do business recruits from certain schools have a different impact than others?* Conducting this type of analysis could help banks strategically rethink their hiring tactics in terms of what they can offer recruits regarding culture, innovation, motivation, rewards, and leadership development.

Banks may also need to provide alternatives to compensation that give new employees a greater sense of belonging, increased job satisfaction, and opportunities for mobility. In

HOW CAN BANKS WIN THE TALENT WAR?

- **Reset the "employee value proposition."** Banks that aren't currently emphasizing ideals and rewards that are aligned with the goals of their employees and job candidates are at risk of falling behind. Develop a clear value proposition for employees that is woven into the recruiting strategy, compensation, and corporate communications.

- **Reassess non-revenue employees.** Companies that assess the compensation and costs of such employees may find that the costs of such work are uneven across the enterprise, based on where employees are located and/or their compensation compared to peers.

- **Transform HR service delivery.** Such a transformation can help companies effectively and efficiently manage the size and scale of a workforce.

this mix, banks should also consider making a cultural shift toward a shared outcomes approach in which employees are more engaged in the company's interests and its long-term effectiveness.

Even as these new requirements address how employees will earn incentive compensation, they also force banks that may have focused on short-term gains to take a longer-term perspective on earnings and revenues. In the process, banks can gain greater stability, and employees may even earn better, more consistent incomes over the long haul.

In addition, banks should have world-class talent at the helm of their regulatory compliance operations—and there are a limited number of those people. Banks should consider being prepared to compete heavily for their skills.

Double down on data transparency

AFTER years of growing through acquisitions, some banks are left with hundreds of disparate information systems across their enterprises. That can be a serious challenge for banks that are under more pressure than ever to provide information to regulators in a shorter amount of time. Just as important, all that data holds the potential to help fuel organic growth. Customer analytics, segmentation, loyalty, and pricing are only a few areas where greater transparency within the organization could lead to even greater transparency for external stakeholders, including investors.

Integrating these systems can be difficult. But as many banks begin to grapple with data assets that have different underlying descriptions and definitions, it may become easier for banks to report exactly what assets they have. For example, it may be easier to accurately report which commercial real estate assets a bank owns once an integrated data system recognizes that one business at a bank describes commercial real estate using different terminology than another business unit.

Under Dodd-Frank, many banks are being forced to improve the connectivity and integrity of their systems so they can satisfy various federal regulators. Banks should consider standardizing data assets so they can report and monitor systemic risk, use analytics to help management and boards enhance their decision making, and improve back-office operations. At the same time, banks should consider leveraging data from information systems set up solely for regulatory purposes. Banks can add different access points to regulatory information to help them manage their business more effectively. Essentially, banks can use these systems for multiple purposes rather than reconciling them.

These transformations could also provide banks with a better understanding of what's on their balance sheets. They can determine which businesses are performing well and gain additional insight more quickly and easily into which ones are losing money. Banks might also use data analytics to improve customer service and cross-sell products to increase revenues.

HOW CAN BANKS FOSTER DATA TRANSPARENCY?

- **Develop an overall data governance program.** With a data governance program and target enterprise architecture, companies can centralize and standardize sources of key reference data. This may help establish a source of customer identifiers, customer instructions (settlement instructions), product identifiers, and the tagging of trades to counterparties (so counterparty risk can be quantified in case of a potential default).
- **Track trades and positions by legal entity counterparty.** Companies can improve systems to better track trades and positions by legal entity within their organization and with counterparties.
- **Improve operational efficiency.** Companies should consider assessing and eliminating redundant data stores.
- **Create a continuous process.** Companies should consider establishing a process model with virtual reference data stores that leverage one source of data, customized to a data mart.

A glass half full

THE Dodd-Frank Act imposes a significant burden on banks to comply with regulations designed to reduce risk and improve transparency. It represents a seismic shift in how banks will approach the way they operate and conduct their businesses. It is already changing how they manage capital and operational efficiency, address compliance and risk management, recruit and retain talent, view data, and provide transparency.

This has created a lot of pain for banks in a short amount of time. But those that look beyond mere compliance to find opportunity may find plenty. While the timing may be challenging, in some cases the legislation creates advantages that can pay big dividends over the next few years and beyond. For many, this will require a major shift in their approach. Meetings that used to start with, "What do we have to do to satisfy this requirement?", will begin with, "How can we use this requirement to our advantage?" That's a far cry from what's happening at many banks today. But it's exactly the approach that banks should consider adopting to win in the future.

Because there is a lot more to know about the Dodd-Frank Act, Deloitte also prepared a series of "takeaway" insights that focus on more specific issues such as compensation, stress testing, derivatives, consumer protection, the Volcker Rule, and living wills.

You can find our takeaways, along with other related information, at deloitte.com/us/finreform

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