



The sound of rumbling thunder  
Assessing the impact of U.S. financial  
regulatory reform





## Introduction

For months, the legislative barometer has been signaling change amid the rumble of distant thunder. Now the storm has broken: President Obama has signed into law the monumental “Dodd-Frank Wall Street Reform and Consumer Protection Act.”

It represents a tumultuous storm that will likely blow for years, impacting many aspects of how financial firms do business and interact with their corporate and retail customers and other stakeholders, including analysts, regulators, and, not least, shareholders. Given the extent of change, it is important that financial firms understand what the legislation will mean for them as well as their customers. Since the recent financial and economic crisis erupted, financial firms have already experienced noticeable change in the number and consistency of their interactions with regulators. As new rules and rule-making bodies are established and take effect, there will be an ongoing management challenge for financial firms of all kinds.

While it is understandable that the U.S. financial industry’s main focus has been on this act, it has not been the only regulatory storm on the radar. Consider:

- The Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009 already has enormous significance for retail finance.
- Many fear that Basel III or potential future G20 reforms could turn out to have an even bigger impact on the financial industry. There is a real concern that in years to come the capital and liquidity implications of Basel III, for example, could dwarf any required increases or reformulations that result from the new U.S. laws. Banks will continue to watch the evolution of the Basel Committee’s deliberations closely before the next round of pronouncements later this year.
- Insurers will likely continue to see Solvency II as perhaps the main driver of their future, even though important aspects of their business model are potentially impacted by U.S. financial reform – specifically their use of derivatives for hedging exposures rather than for principal trading.
- The federal banking agencies have issued incentive compensation guidance that will require banking organizations to scrutinize closely and make appropriate changes to compensation arrangements so they are tied to long-term performance and do not encourage excessive risk-taking.

It is also important to keep regulatory reform in context. What will really drive earnings in financial services for the next 15 years? How the U.S. (and global) economy performs will likely be at least as, if not more, important than new rules, particularly as participants attempt to “free up” their balance sheets by monetizing distressed assets. As the new rules crystallize, there will be an ongoing impetus for financial firms to monitor them in the context of their overall business strategies. That said, for many the rules are likely to play a powerful shaping role as firms come to terms with new business structures and levels of risk-adjusted profitability.

Because the new U.S. law is complex, it can be helpful to remind ourselves that its underlying purpose is relatively simple and has two powerful strands:

1. “De-risk” the financial system by constraining individual organizations’ risk-taking activities and capturing a broader set of organizations’, including the so-called “shadow” banking system, in the regulatory net
2. Enhance consumer protections

Of course, the law contains a host of other measures designed to clear up other matters or to introduce new checks and balances. One notable omission is that the U.S. regulatory structure, although slightly simplified, has not been overhauled fundamentally and remains rather fragmented (with the possible exception of systemically important institutions). That may be a challenge, especially for the new systemic regulator as it seeks to form a view of the aggregate risks in the financial system and the economy more broadly.

As the details of the new law turn into specific regulatory requirements, there will be business impacts across all of financial services, not just banking. Some of those impacts are obvious. For example, the need for “arm’s-length” swap desk affiliates combined with the move from over-the-counter to exchange trading for derivatives, tighter constraints on leverage and risk-taking, and higher liquidity requirements imply lower profit margins in future from those activities. For a few financial firms (as well as for their corporate clients who are end-users of many of these products), that may represent a serious and strategic issue. The same is true for insurers, which tend to use derivatives and swaps primarily for hedging.

However, other impacts are subtle and do not stem directly from language in the new law. The law mandates a new consumer protection body, which over time is expected to evolve a set of standards and enforcement mechanisms that are unprecedented. A likely consequence is that financial firms may have to rethink their entire approach to product innovation. In future, each new product may have to be designed with an eye toward whether it might expose the innovator to unacceptable downside risk because of the challenges presented by the new consumer protection standards. Indeed, it is conceivable that new strategies will be predicated on the assumption that these standards are the starting point for product design. This is a radical shift, yet the words “product innovation” are not named in the new law. Many of these more subtle impacts will only be evident as further flesh gets added to today’s legal bones based on directives and practices that will likely emerge over the coming months and perhaps years. Incidentally, the impact of consumer protection on existing financial products is likely to be similarly profound and is likely to produce a new generation of features and services.

Regardless of its financial services sector, each firm will potentially face a different set of implications based on its unique business mix and organizational structure. It is probable that some of the consequences of financial reform will be “unintended,” i.e., we won’t know what they are until they have begun to happen and they will not be what the framers of the law had in mind. By way of example, a driving element of the law has been to address the “too big to fail” issue, reducing the risk that large firms might take excessive risk because they are in effect guaranteed to be bailed out in the event of failure. But because this is an extremely complicated problem, no one actually knows what the consequences of the new law will be – the new systemic regulator will probably make this a central issue as it sharpens its mandate in the coming months.

That said, however, we think there are certain implications of reform that, if not universal, are of broad importance. Clearly, the list is not exhaustive and there are many ways to slice this complicated pie. But we have picked these seven for their ubiquity:

- Being (or not being) systemically important
- Legal entity/structure
- Capital
- Data and business information
- Governance, oversight, and accountability
- People and culture
- Regulatory change management

#### **Being systemically important (A) or not (B)**

The new law will see the future designation of “systemically important” institutions, some of which are likely to be nonbanks and insurers. Firms in Group A will face new information and reporting provisions, although it is likely to be some time before we will know precisely what they are. Some will probably be extensions of existing regulatory techniques. For example, stress testing appears to be becoming a routine examination technique. In some cases, the scenarios being developed for so-called “reverse stress tests” are improving management thinking about their business mix and the adequacy of contingent liquidity plans.

There will likely be other new areas of impact from the systemic regulator. At the most basic level, the regulator is likely to request information not currently generated by banks and other significant firms. It is also likely that it will continually shift its demands as it monitors different aspects of risk in the financial system, suggesting Group A will probably need to adopt more dynamic information provision capabilities. There may also be new information demands, such as requiring registered advisers that are deemed to be systemically important to make new reports regarding private funds. In addition, the making and maintaining of “living wills” as part of a new focus on resolution represents a further set of costs and practical issues.

It may be tempting for those in Group B to assume that they can continue with business as usual, i.e., that the new law will not directly impact them in this respect. However, this is likely not to be the case. By definition, just below the systemically important group is another group that we can call “almost there but not quite.” These firms run the risk that a change in the systemic environment could be deemed sufficient by the regulator to pull them up to Group A. It is conceivable that as the new regulator gears up it might impose new reporting requirements specifically to monitor Group B for signs of increasing riskiness. Markets are dynamic and so will be the evolving information needs of the systemic regulator.

#### Legal entity/structure

The new law may have an impact on most financial firms’ organizational structures, particularly their legal entities. Existing structures are often complex, having evolved over many years. Even before the legislation passed into law, many firms had begun the process of examining their organization charts to determine what might need to be rationalized. This has typically included a detailed review of the activities undertaken in each subsidiary. Under the new law might some or all of these activities need to be relocated to a new entity? Might provisions in the new law mean that certain entities are no longer required? Such work will be ongoing, and not just for bank holding companies (BHCs). There are clearly implications for insurers, too, because some of them will become systemically important and many of them have complex business links with banks as counterparties.

From a systemic risk perspective, rationalization of legal entity structures could bring big gains, not least by making it easier for counterparties to manage their aggregate exposures – an area where regulators have put pressure on leading institutions, including some large asset managers and hedge funds, to improve their ability to form timely assessments of counterparty risks.

However, the new law also implies the emergence of new entities, notably with regard to the “Volcker Rule” limiting proprietary trading and private equity activity by banks that are otherwise backed by taxpayer-funded guarantees. This led to much speculation during the legislative process, with many banks, including the largest institutions, arguing that

their proprietary trading activities contributed only a small percentage of annual revenues. It is likely that the “rule” was intended to capture a much broader set of activities, emphasizing a distinction between trading done purely for customers and trading done on a bank’s own behalf, but not segregated on a ring-fenced proprietary trading desk. That view implies a much more fundamental set of impacts, not least of which is an economic review of activities that assumes they need to be in separate entities with all of the associated costs. This is an area where firms across financial services will likely have to make careful decisions regarding structures and the location of their activities.

There are likely to be considerable tax implications as legal entities are altered. This exposes financial firms to one-off costs and technical challenges that are specific to existing structures. But it seems clear that there will be a need for firms in all sectors of the industry to rethink and optimize their tax structures in light of new rules.

In some cases, the impact of financial reform will hit directly on existing legal entities which in the past perhaps had not attracted close scrutiny. For example, the law addresses the importance of systemic stability of the payment system – the clearing, settlement, and custody services that move money and securities around – by creating the new designation of a financial market utility. These firms will attract specific regulatory attention and be given access to the Federal Reserve’s discount window in times of market turmoil.

#### Capital

From a capital and liquidity perspective, in future, financial firms will likely need more and better-quality capital, and modeling and deploying that capital will be even more important than ever as a critical core competency of management. The fact that tougher standards are likely to be linked to new liquidity requirements only raises the bar. The new regulatory regime may make it much harder to assume risk via leverage or liquidity mismatches. This is not simply a consequence of the new U.S. law, but rather a reflection of activity across several fronts. For example, the Basel Committee is leaning towards a much tougher international capital and liquidity regime that would particularly impact financial firms with international

banking operations. At the same time, investors remain nervous of any sign that financial firms might take too much risk without sufficient capital support or that they might rely too heavily on short-term funding.

Financial firms will respond in different ways to the new regime. Some may choose to migrate toward lower-margin, flow-type businesses that are less capital intensive, while others may chase higher returns. Growth in these activities, however, may be constrained by a combination of higher capital requirements and lower margins. For example, moving derivatives trading onto exchanges is likely to make this capital-intensive activity much less profitable as both more demanding capital standards and newfound transparency drive margins lower.

Linked to broader efforts to reduce the likelihood of future banking crises, regulators have been advancing the cause of new forms of capital, in particular so-called “contingent capital,” effectively subordinated or other forms of debt that convert to common equity under prescribed conditions. This has caused much debate, with critics arguing that the act of converting such debt to capital would send a distress signal to the market, leading to the exact failure the capital is intended to avoid. However, it seems likely that the concept will be endorsed globally. And it could be explicitly linked to the related issue of pro-cyclicality, whereby banks tend to engage in riskier activities in good times and are then prone to crises when bad times arrive. In future, banks might be required to hold portions of contingent capital that increase in line with economic growth, so that they enter bad times with a bigger cushion. This could add significant new costs to the system, lowering returns.

The capital regime will present an ongoing challenge for many banks and other financial services providers. Low interest rates and government support have helped many banks to strengthen their capital bases, but leading rating agencies have explicitly said that several of the biggest institutions would have significantly lower credit ratings without these. As the new law is implemented, these organizations may find themselves in a race to stay ahead of the ratings consequences – they may avoid downgrades only if they can build their capital or shed troubled assets faster than reforms bite.

Financial firms will also have to adapt to an emerging tension between national and international capital constraints. Even as the Basel Committee works toward a new set of international standards, new or tighter rules in individual countries have raised the danger that capital could be trapped inefficiently at local levels, thus decreasing the attractiveness of operations in these markets. Again, this will probably play out over a number of years, but it represents a new dimension to capital management.

Managing liquidity is expected to continue to be a major preoccupation for many financial firms, especially those with large international operations and complex trading books. The new systemic regulator is expected to build on work already underway in bank supervision that was designed to make banks’ liquidity provisions much more robust. It was observed during the financial crisis that reliable liquidity earmarked by individual institutions was in fact subject to withdrawal or simply unavailable because of nondelivery by a counterparty. Given this situation, U.S. regulators are now exploring how banks and other institutions can model their liquidity so that it can be relied upon to see them through a set period of time, literally on a day-by-day basis. International liquidity measures are likely to extend this approach by distinguishing between immediately available and short-term liquidity versus medium and long-term liquidity. This approach will be both complicated and costly to implement.

Capital and liquidity are central to the soundness and operations of financial firms, so it is no wonder that new regulations will directly impact both. There might be a new twist to the current round of changes. Not only will leverage explicitly be limited in the future, but the scope for capital “arbitrage” is likely to be small. Regulators are likely to frown on perceived efforts to avoid capital charges, while firms also risk political backlash and reputational harm if they seek to do so. By itself, this represents a significant change for the entire industry.

### Data and business information

At the heart of the new law's efforts at systemic de-risking and consumer protection are data aggregation and integration requirements to enhance timely and accurate reporting. There will likely be the need for numerous touch points, even though the law itself appears to reference only the submission of various data to the relevant regulators. This is particularly the case regarding the new systemic regulator, which is expected to ask financial firms for new types of information.

Regulators, most notably the Senior Supervisors Group in its October 2009 report, have cited the complexity of the industry's technological infrastructure as a key hindrance in identifying and measuring risk within the system, making this area a likely candidate for further focus in the future. In response to both increased regulatory scrutiny as well as their own risk management requirements, banks have become more aware of their need to distinguish between data – the raw numbers that populate systems – and business information – a way of viewing or describing data that conveys something and allows the user to make inferences or decisions. In meeting these requirements, banks continue to grapple with the need to extract data from a plethora of legacy and other systems to create more meaningful information. The issues created by these complex environments are of equal importance to insurers, which have similarly complex data and systems architectures and will probably face similar regulatory pressures.

Adding further weight to the importance of data access and reporting are the linkages between the regulators' requirements for better risk management and governance. Combined, these serve to create a further impetus for improvements through the board's seeking information needed to meet its fiduciary and management responsibilities.

The challenges of information provision are significant. However, integrating data across an organization can also yield significant benefits in the form of lower finance costs, more effective capital management, and more informed strategic management of business portfolios. Financial firms that work successfully to improve their data and information management might open some competitive clear water between themselves and others. They might also relieve some of their regulatory burden. As with other impacts of the new regulation, this will require a multiyear effort. And while much of this impact will be felt in management information systems (MIS), operating systems themselves may also be affected, especially where reorganizations are required and where present system configurations do not produce the data needed to support the new or revised MIS applications. In addition, the plethora of data does not diminish the importance of judgment and accountability in decision making.

If experience is any guide, the anticipated new data and reporting requirements will probably take quite some time to be implemented and are likely to be phased in over a period of several years. From the industry's point of view, this offers an opportunity: to work with the regulators to develop reporting requirements, formats, and timetables that are practical to implement and enable both regulators and the regulated to meet their respective obligations. The requirements, though not fully defined, are likely to be burdensome, expensive, and will not go away. There will be considerable impact on smaller and medium-sized banks. Participants in the financial services industry will, however, have opportunities to provide meaningful input, individually and through industry associations, and to use the dialogue with regulators to help them develop their own cost-effective compliance strategies.

## Data Challenges

In light of the altered data requirements under a reformed regulatory regime, many financial services companies may want to consider data quality and integration issues in the following areas:

- **Customer data** and the extent to which it is housed in multiple systems without a unique customer identifier
- **Legal entity data** and the extent to which it is replicated and maintained within multiple systems leveraging incongruous legal entity relationship constructs
- **Product codes** and the extent to which it is not standardized across systems and defined with distinct hierarchies
- **Contract data** and the extent to which they are not consistently captured and centrally stored
- **Position data** and the extent to which intensive manual scoring and mapping processes are required and are unable to be reconciled between risk and finance data
- **Transaction-level data** and the extent to which it is not tied to its requisite summary data, making analysis of anomalies a manual—and sometimes difficult—task

## Governance, oversight, and accountability

In many ways, a key to the entire de-risking effort of the new law will be how it adds to existing drives to improve the governance of financial institutions. To avoid significant disconnects between front-line operations and the understanding and control of those by senior management, including boards, regulators in many countries have recommended new management practices and increased their oversight. The underlying belief appears to be that better governance, particularly of risk processes, should lead to firms making better risk-informed decisions and ultimately to a lower riskiness of the system as a whole.

The new U.S. law, with its emphasis on safety and soundness, is likely to add to this momentum. At a *Compliance Week* roundtable sponsored by Deloitte<sup>1</sup> in January, chief risk officers at various financial firms noted that there have already been changes in how boards function. For example, in the past it was common practice for a board risk or audit committee to be given a weighty document – often running to hundreds of pages – prior to its regular meeting with management, and for the meeting itself to be dominated by the presentation of reports by management, leaving little time for discussion or debate. The CROs at the roundtable pointed out that increasingly boards are asking for shorter, more meaningful reports and are using the meeting to engage actively with management rather than passively receive a mass of information. This is a trend strongly encouraged by regulators and by the spirit of the new law.

With its focus on the financial system, the new systemic regulator is also likely to add to pressure for firms to have a better grasp of their risk taking at the enterprise level. Many financial firms have CROs who sit above any risk management structures inside business units and try to manage the firm’s overall risk profile. This creates a single senior point of contact for regulators seeking a high-level understanding of where a firm might have risk concentrations that could have systemic implications. However, there are firms where, for historical or legal entity reasons, the risk function is still fragmented and siloed. The accountability for risk governance sits not just with the board but spans the organization, and will likely have to be realigned to meet the new expectations. When the new law is applied by regulators, it is likely to encourage these firms to reconsider their governance structures.

Although it is too early to be certain as to the precise nature of change, we can say with some confidence that the new law’s impact on consumer protection will also have potentially profound effects on the governance of retail-facing financial institutions. In order to protect themselves from regulatory interventions and possibly from legal risk (disgruntled customers or shareholders), boards may have to introduce new codes of conduct or

<sup>1</sup>As used in this document, “Deloitte” means Deloitte & Touche LLP, Deloitte Consulting LLP, and Deloitte Financial Advisory Services LLP, which are separate subsidiaries of Deloitte LLP. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

management principles that seek to ensure compliance with the spirit as well as the letter of the new regime. As with other changes, it will likely be years before governance rules and practices are established and aligned around consumer protection. But absent a future repeal of the law, this will likely mean that retail firms will make consumer protection a central element of their governance structures.

### People and culture

An important consequence of the new law concerns what we might call the “human capital” management dimension of financial firms: How do you make sure you have the right people in the right jobs? How might roles have to shift to reflect new regulatory demands? Are your processes ready for a slew of changes that will follow as the new regulations are implemented? We can think about potential impacts across three main dimensions:

- **Environment and culture** – Financial firms need to understand what is expected of them and adapt to those expectations; for example, what is accepted behavior around sales processes in light of new consumer protection rules?
- **Organization** – Financial firms may need to consider whether their organization’s infrastructure and structure require adjustment as a result of new requirements; this could be enterprise-wide or function specific (e.g., compliance or risk organization).
- **Talent** – Financial firms will likely need to make sure the organization has the right people with the right skills and experience; this consideration pertains to both existing and new employees.

Although they have often received less attention than issues such as capital and liquidity, these organizational factors are potentially important to meeting the main goals of the new law. In recent years, regulators have been taking greater interest in firms’ cultures and organizational practices. That trend is likely to continue.

## Potential action steps on people challenges

### Environment and culture

- Stakeholder management (who needs to be involved, informed, made aware, and influenced)
- Business case for change (need to understand reasons for change and consequences of noncompliance)
- Communications (people need to know what is going on)
- Ethics and behavior (tone at the top, leading by example from the board)

### Organization

- Operating model/organization design (reporting relationships, spans of control, and work/process flows)
- Decision rights (who makes which decisions and who has approval authority)
- Roles/responsibilities definition and job design (or redesign)

### Talent

- Hiring profiles (new/different skills and experience required)
- Onboarding (accelerate productivity/effectiveness; potentially, there could be a large number of hires required to build up regulatory functions)
- Learning and development (skills assessments – new skills required, actions to address gaps)
- Performance management (goals, metrics, and expectations)
- Succession planning and preparation (leadership and key roles)

### Regulatory change management

One aspect of cultural change is that many large financial firms are beginning to create what amounts to a new managerial cadre whose job is to serve as quasi-diplomats with respect to the regulatory bodies that oversee them. In the past, there was little perceived need for the strategic management of relationships with regulators, let alone with politicians. In the future, this will likely become a standard practice. The role of regulatory "ambassador" has arrived. As envisioned, the new ambassador would bear considerable responsibility for a financial firm's overall strategy and positioning. In addition, the ambassador could work with regulators, becoming a channel for the introduction of improved management practices and better two-way communication.

Change is a process, and there could well be further new laws (or repeal of some aspects of the new law) in the future. During the 1930s, for example, the Glass-Steagall Act was enacted in 1933. The Investment Company Act, also of huge significance for the financial industry, was not enacted until 1940. Today, firms will likely need to remain aware and alert to the potential for further changes. They will also have to accept the fact that it could well be years before the system settles down to an accepted set of rules and regulations. Regulatory uncertainty will be ongoing and global in nature.

### Conclusion

It is no exaggeration to suggest that the "Dodd-Frank Wall Street Reform and Consumer Protection Act" will trigger a realignment that is set to challenge financial firms in fundamental ways. They will likely have to reexamine their business models. At the highest level, they will likely need to think through the future nature of their proposition to stakeholders given that there will be constraints on everything, from growth to executive compensation. It is the biggest set of changes in a generation, perhaps the biggest since the 1930s. Moreover, the regulatory storm will rumble on globally. Only with time will it become clear how the consequences of U.S. domestic reforms will compare with those of proposed changes elsewhere. The sound of rumbling thunder is likely to be audible for many months, even as financial firms get down to the business of reacting and responding to the new U.S. law.

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