Preface

The Great Financial Panic of 2008 set in motion the most significant upheaval in financial regulation in the last century in both the United States and most other major financial markets. In November 2008, the Group of Twenty (G20) world leaders met at a historic international summit in Washington, DC, to take the unprecedented step of revamping the global financial architecture. The G20 vowed to leave no part of the financial world unregulated and established a new Financial Stability Board to oversee and coordinate their new global policies and regulatory reforms.

In the United States, the Bush Administration and the 110th Congress passed the Emergency Economic Stabilization Act in 2008 (EESA) as a direct result of overwhelming populist reactions and political backlash against financial institutions. This first response was designed to not only stop the bleeding through an extraordinary grant of authority to the Treasury Department to manage the outcome. It also planted the seeds of a new regulatory reality and fundamental reform. Next, the Obama Administration and the 111th Congress enacted the most sweeping financial reform legislation—the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act or DFA)—in modern history.

The combined effect of these two pieces of legislation has created a new regulatory reality that will impact management teams and boards of directors at all kinds of financial services firms, regardless of size and complexity. This result is an undeniable fact from the continuing political fallout and regulatory process of translating 2,300-plus pages of new law into hundreds of new rules.

There are three key facts about the new regulatory reality that every financial executive and every board member who wants to be a winner needs to understand:

Fact 1: *The financial regulatory world has changed fundamentally as a direct result of the financial crisis, and a profound new regulatory reality is with us for the foreseeable future, lasting decades.* The passage of the Dodd-Frank Act is just the first step of this journey. Being able to fully understand its cumulative impact on end users and unintended consequences for our economy will take years as further studies are conducted and new rules promulgated.

Fact 2: *To complicate the already difficult challenge of serving customers in a highly competitive global marketplace, governments—with especially the U.S. government in the lead—are intervening more and more into what used to be private decisions of corporations.* Policymakers and regulators will have a greater say in the basic strategic and management decisions being made in the financial services sector of our economy than at any time in history. These range from the types of products and services offered, to potential pricing effects, to setting "reasonable" levels of compensation while banks recapitalize to new required levels. This policy and regulatory intrusion also will affect the potential movement of entire business lines and skilled workers to other industries and other financial centers, to the likely long-term detriment of our economy.

It may have been cathartic for politicians around the world and specifically in the United States to blame bankers indiscriminately for the crisis. Some commercial bankers, mortgage brokers, investment banks, the credit rating agencies, and others were to blame. Many of these have failed as a result. Yet the surviving banks and other financial companies that want to be winners, serve their customers, and finance the U.S. economy—from the smallest community bank to large global competitors—now face the burden of operating in a new regulatory reality that most of them did not cause. The Dodd-Frank Act will create additional challenges for survivors as they strive to meet the needs of their customers under a crushing new regulatory burden in the midst of a laggard economy with little growth potential on the horizon.

Fact 3: *As a result of Facts 1 and 2, financial executives and directors have no choice but to reengage policymakers and regulators in 2011 and beyond.* They will need to do so individually and collectively, fully armed with facts and logic to ensure the most balanced outcome possible as Dodd-Frank proceeds to its ultimate conclusion at the end of the rule-making process in the years ahead. This fact is especially true in light of the 2010 midterm elections, which produced a divided government and a divided Congress.

Understanding not only how and what the legislative process wrought, but more important what lessons financial executives and directors can learn and embrace before the next crisis, is imperative for those who choose to survive and prosper in this new regulatory reality. This obviously is important for individual companies, but it also demands a call to arms by the industry to engage aggressively on those issues that have the greatest impact on their

ability to serve their customers and earn a competitive rate of return for their investors.

THE NEW REGULATORY REALITY

So what exactly is this new regulatory reality?

For purposes of this book, I define the new regulatory reality simply as *the ascendant and expanding role of government over the financial services industry*. It now is weighted more in favor of financial stability to prevent future systemic risks, as compared to a more balanced approach for efficiently meeting the needs of consumers and the economy through continuing innovation, fair treatment for customers, ethical business practices, prudent risk-taking, and more effective supervision across financial markets.

This new regulatory reality springs from the understandable political backlash from the worst financial crisis in modern history, which the International Monetary Fund (IMF) estimates wiped out one-quarter of gross domestic product (GDP) in major economies. Consequently, it demands a greater political sensitivity by firms and their owners going forward. The new regulatory reality, which had its genesis in EESA but now is embedded fully in the Dodd-Frank Act, could easily translate into tens of thousands more pages of rigid new rules to govern all aspects of financial intermediation and risk-taking in the future.

Consequently, the new regulatory reality will demand a disproportionate share of management and boards' time and energy to get their corporate and industry response right in the years ahead.

First, CEOs and their executive teams can be expected to spend 50 percent of their time on reassessing strategy, rethinking business models, increasing productivity, cutting costs, and finding new and better opportunities to serve their customers. Second, another 50 percent of their time is likely to be spent managing to this new regulatory reality in the next few years. Finally, senior management teams will have to focus yet another 50 percent of their time doing a better job of managing day-to-day risks and living good corporate governance day by day. They will have to ensure not only the right risk policies and practices, but also the right risk culture, one in which potential "issues" or problems are able to be raised to the attention of senior management in a timely and transparent manner—before regulators need to intervene and it is then too late. Regulators are always looking to see who is setting the "tone at the top," exactly what that sound of that tone is, and how it resonates throughout the company.

If I have done the math correctly, the new regulatory reality is more than a full-time occupation. Therefore, financial firms will need to step up

how they manage their unique regulatory risks and new supervisory environment to support their ongoing competitive strategies and business models for serving customers. Boards of directors, which are likely to receive even greater scrutiny from regulators than in the past, will need to be on top of these developments as well.

Financial supervisors also will remain under intense political pressures to carry out both the letter and the spirit of the new law. Moreover, they will come under increased fire from policymakers if they deviate from its requirements, even if time and prudent judgment suggest a different response would be better. This is a target-rich environment, to borrow a military analogy.

In summary, this reality for financial institutions can be defined by at least four factors in the United States and many other G20 nations as well:

1. Greater government intervention in financial firms and markets, including the additional risk of greater political influence as well.
2. Heightened prudential standards, ranging from higher capital and liquidity requirements to new concentration and risk requirements.
3. More intense supervisory scrutiny, especially for larger national and globally active financial firms.
4. Higher regulatory burdens, including higher costs both direct (e.g., new assessments and fees) and indirect (e.g., compliance costs, lost revenue streams).

Moreover, it won't get any better or easier in the near term. There is a multiyear transformational change under way in both global and national financial regulation. It will have a lasting impact on the structure, conduct, and performance of financial institutions and their role in society for the foreseeable future. The management challenge in the United States emanating from the Dodd-Frank Act is staggering, for both private sector firms as well as their supervisors who are taking on an awesome new responsibility and also have to get it right.

WINNING IN THIS NEW ENVIRONMENT

On my very first day as the new political appointee at the U.S. Treasury Department in 1986, I had a brief meeting with a man I greatly admire, Treasury Secretary James A. Baker, III, my ultimate new boss. It was my first one-on-one meeting with Secretary Baker and a chance for me to hear his views on behalf of the Reagan Administration for resolving the savings and loan crisis. As I got up to leave after about 10 minutes, Secretary Baker had one last piece of advice for me, one that sticks with me to this day:

"Remember one thing, Greg," he said with his wry smile, "there are winners and there are losers in Washington, and it's always better to be a winner. So make sure this administration is a winner."

Winning is a central thesis of *Managing to the New Regulatory Reality: Doing Business under the Dodd-Frank Act*. If financial services CEOs, senior executives, and their boards of directors want to be winners, then they will have to manage their unique risks in this new regulatory reality better and more effectively than in the past.[1] They will have to be even more proactive in the future than in the past—thanks to the continuing financial, economic, social, and political fallout from the global crisis.

This new fact of life applies especially to the management teams and boards of commercial and investment banks, but it affects all financial institutions, including insurance companies, hedge funds, and even private equity firms that increasingly are being subjected to bank-like regulation. Financial executives simply cannot afford anymore to react after the fact. Obviously, managing the overall risks of a financial intermediary—credit risk, interest rate risk, market risk, operational risk, and legal risk—on an enterprise-wide basis is critical to the performance of any firm, but it also is beyond the scope of this book.

My hypothesis applies to all financial firms, but it takes on an even greater sense of urgency in this environment for those firms that may be viewed by policymakers or regulators as systemically important financial institutions—commonly referred to as SIFIs in the media. Global SIFIs—recently dubbed G-SIFIs by the Financial Stability Board at the G20's Seoul Summit—will get even more intense supervisory scrutiny in the future. In this book, I use the terms "Title I companies" and the new "Financial Stability Club" interchangeably, referring to those large, interconnected financial companies that are most impacted by the first title of the Dodd-Frank Act. As the Great Financial Crisis of 2007 to 2009 demonstrates, some large firms like Lehman Brothers may be allowed to fail for a variety of reasons by policymakers and regulators, while others like American International Group (AIG), Wachovia, Washington Mutual (WaMu), Freddie Mac, Fannie Mae, and even nonbanks like General Motors and Chrysler are viewed as "too big to fail" or "too interconnected to fail" by those same policymakers and regulators, and therefore they are saved by different means.

Regardless of any arbitrary designation by the financial markets or by governments, senior management in all financial firms will need to do a better job in the future of not only actively managing their own peculiar regulatory risk, but also the collective risks to their reputation as a foundational industry for our economy and society.

Remember, it's better to be a winner than a loser.

THE PURPOSE OF THIS BOOK

Very simply, I had three goals in mind when I decided to write *Managing to the New Regulatory Reality.*

First, before the next crisis strikes—and there will be more financial crises, the new Dodd-Frank bill and G20 platitudes notwithstanding—I want to offer a reminder of the severe political and regulatory forces and reactions in the wake of a financial crisis to all who will listen. My hope is that the mere potential for future political reactions to the next financial crisis on a level of what we have just experienced will be enough for the private sector to do a better job of policing itself and relying on market discipline—before companies face the gale winds of unrelenting political backlash and potential regulatory overreactions again.

Second, I want to offer my hypotheses on what I believe are 10 universal lessons to be better prepared for the future, which I think are important for executives, directors, and others to understand and embrace as the new regulatory reality unfolds over the decade.

Third, I want to stress the need to engage as individual companies and as an industry that finances and protects the U.S. economy. The Dodd-Frank Act was not an end point; rather, it is a new beginning to engage policymakers and regulators, and then engage them some more to get the balance right for customers, recovery, and growth under prudential new rules.

Throughout my career, I have worked in more than 15 countries that have experienced a financial crisis, starting with my work at the U.S. Treasury during the savings and loan crisis of the late 1980s up to and including my work today as a consultant in the private sector during this crisis. In between, as a partner with McKinsey & Company based in Washington, DC, I served a variety of public and private sector clients on a variety of crisis-related issues, ranging from how to pull a country out of the abyss to finding new competitive opportunities out of the creative destruction that occurs in every financial crisis.

While still a partner with McKinsey, I had the privilege of coauthoring another book for Wiley Finance—*Dangerous Markets: Managing in Financial Crises*—with two respected colleagues and good friends, Dominic Barton, now the managing director of McKinsey & Company worldwide, and Roberto Newell, now the chairman of Instituto Mexicano para Competitividad, a respected think tank in Mexico. While I occasionally will draw out some key lessons from our work together during the Asian and Latin financial crises that are applicable today and in every crisis in the future, my singular focus in this book is to get senior financial executives and their boards of directors to proactively manage their own individual regulatory and industry reputational risks better in the future.

One of the great personal disappointments after coauthoring *Dangerous Markets* was the fact that the financial markets and entire national economies, including my native country, would be consumed by a global crisis of such proportions so soon after the Asian financial crisis. Frankly, that is both unacceptable and unforgivable. We stated when we wrote our book that we knew there would be future crises and that senior financial executives as well as policymakers and regulators could be—and should be—better prepared for the next crisis as a result of learnings from the last crisis. Unfortunately, we were wrong.

Obviously, not every crisis is the same, and our next financial crisis is as likely to be as different from the most recent one as it is similar. The next crisis could just as easily be a sovereign debt crisis with its epicenter once again in the United States, which could be even more devastating than the last crisis. Too few observers, myself included, had the foresight to see the full force of this financial storm before it engulfed us in August 2007. Too few could predict the Great Financial Panic of 2008, or what Bill Isaac, the former chairman of the FDIC, calls the "senseless panic" in his new book, as markets seized and shut down.

So, as someone who was forced to react and respond to the U.S. savings and loan crisis while a mid-level political appointee at the Treasury Department in the late 1980s and later helped clients in other crisis countries while a McKinsey partner, it is a deeply personal issue for me to offer my observations and reflections in writing. Hopefully, my musings will help others either avoid the next crisis through their personal actions ahead of time, or at least mitigate the full potential impact once a crisis does strike. I will hope for the former, but anticipate the latter.

There will be future crises, despite all of the new legislation, new regulations, and new books that are written in the hopes of avoiding them. So, be prepared!

WHO THIS BOOK IS FOR

Managing to the New Regulatory Reality is written primarily for senior financial executives and boards of directors at financial firms, both banks and nonbank financial institutions, who are now trapped in this new regulatory reality through no fault of their own. While intended mostly for a U.S. audience in light of the new legislation, executives and directors in other countries should benefit as well from my book's review of the U.S. financial crisis epicenter and the subsequent U.S. and global response and reforms.

From my perspective, the final part of this book should be thought of as universal lessons to be learned, regardless of where you do business.

Obviously, this statement should be read with all the caveats that every country is different, and clearly every regulatory regime has its own strengths and weaknesses as well as threats and opportunities. Nevertheless, the lessons generally should be applicable in all markets and all regulatory regimes, with some tweaking, of course, depending on the particular local circumstances, legacy systems, and starting points after the global financial crisis.

Other audiences hopefully will benefit from this book as well. Attorneys, accountants, and other advisors to financial firms need to understand the political landscape and the new regulatory reality in which they serve their clients as well. Moreover, policymakers and regulators should appreciate this perspective, especially in light of the unique symbiotic relationship between highly regulated firms and their regulators. Finally, students of financial history and regulatory reforms as well as academics should also benefit from this book. While not written directly for these readers, the synthesis of recent history and what are meant to be practical, commonsense observations hopefully will be helpful to a fuller understanding of the crisis and lessons not to be forgotten in the future.

PREDICTIONS

I don't have a magic crystal ball, but I do have three predictions that also are likely to influence the political and regulatory journey through this new reality.

Prediction 1: *The Dodd-Frank Act ultimately will be viewed as an understandable but significant political and regulatory overreaction to the crisis, when its full effect is better known in the months and years ahead.* As a result of the 2010 midterm elections, in which Republicans swept the House of Representatives and increased their ability to block legislation in the Senate, there will be efforts by policymakers and the private sector in 2011 and beyond to correct the excesses and revisit major portions of the law that went beyond a balanced approach to important issues such as adequate capital and liquidity or the interactions of regulators to name a few. After the numerous mandated studies and additional time to pause and reflect on the real causes of the crisis and the harmful actions of a relatively small number of financial institutions, there will be more than just a technical corrections package, but it may have to wait until after the 2012 elections.

Prediction 2: *The cumulative impact of the Dodd-Frank Act will be a drag on our economic recovery and future financial market com-*

petitiveness, in part because of the political and regulatory overreaction. The combined impact of 2,300-plus pages of new laws and an estimated 20,000 pages of new regulations will have a potentially crushing effect on risk-taking, investor appetite for the financial services industry, and the ability to finance our economy at a level needed for sustained economic growth domestically as well as U.S. economic leadership internationally.

Even if the longest U.S. recession since World War II is over officially, we still suffer from an economy in a dense fog with any number of icebergs looming ahead of us beyond Dodd-Frank implementation. We have limited maneuvering room for monetary policy notwithstanding the Federal Reserve's latest round of quantitative easing, and we have a domestic fiscal situation that is out of control with little real relief in sight. Without significant actions to achieve a better balance on the U.S. budget deficits and national debt, we are asking for a fiscal or economic crisis that could trigger another financial crisis before we fully recover from the last one. Left unmanaged, this is a potential threat to our national economic security as well as our international economic leadership.

Prediction 3: *The Dodd-Frank Act will have a potentially perverse impact on the very consumers it was designed to protect*. Despite the positive focus on the new Bureau of Consumer Financial Protection to protect consumers through better disclosure and a curb on "unfair, deceptive, and abusive practices," the more likely immediate impact will be an increase in costs, a decrease in innovation and choice in the short term, and less credit available as we transition to new capital and liquidity requirements and the multitude of other new regulatory burdens come online. Costs to consumers already are beginning to rise from some elements of the bill, such as the pending limits on card interchange fees by the Federal Reserve.

Unfortunately, these outcomes will fall disproportionately on consumers at the lower end of the socioeconomic scale. This includes young adults—like my children—just starting their careers, new families buying their first home, small businesses dependent on credit to survive and grow, and the new entrepreneurs with innovative ideas and products to strengthen our economy, but who are unable to access needed finance and working capital to make their dreams a reality.

No one hopes I am wrong about these predictions more than I. Regardless of whether I am right or wrong, my hope for this book is that

readers have a better understanding about several things than they may have before the crisis.

First, humans caused this crisis, which was transmitted almost instantaneously from the United States around the world by the global capital markets. Humans, not fancy models or more regulation, can help to mitigate the impact of the next one through a better understanding of creditworthy borrowers, better underwriting standards and risk management, and better supervision at both the macro and micro levels. Humans in both the private and public sectors are also the basic building block to ensure that the new financial architecture and regulations are as balanced and effective as possible.

Second, the crisis-induced legislation of 2008 and 2010 was the transmission belt to relay populist anger through the government against an easy target—financial institutions. Yet this overt anger also becomes a means of needlessly punishing thousands of financial firms of all sizes and types for the misdeeds of what in fact were a relative small number of players in the final analysis.

From my vantage point, it is time now for President Obama to declare an immediate armistice with the financial services industry at large—and bankers in particular—in the name of ensuring a balanced outcome for the Dodd-Frank Act that recognizes the fragility of our economic recovery and the important role that banks and all financial services companies have to play in our recovery and growth. He immediately should direct the Secretary of the Treasury to work collaboratively with both financial executives and end users in his role as chairman of the new Financial Stability Oversight Council to avoid any negative unintended consequences of the Dodd-Frank Act on our economy. His selection for the new vice chairman of Supervision at the Federal Reserve Board of Governors should also share this philosophy and this new mandate. We need to find a balanced way forward as we write new rules for our financial system and its role for our economy—before it is too late, and another self-inflicted crisis strikes us.

Finally, with the benefit of even greater hindsight, we need to continue to rethink other lessons, better potential solutions, and needed course corrections in the days and years ahead. I hope that the lessons from this crisis, regardless of whether you agree with my views, will be remembered and practiced before the next crisis strikes. There will be more financial crises in the future, the best intentions of the Dodd-Frank Act and G20 efforts notwithstanding.

OVERVIEW OF THE CONTENTS

Managing to the New Regulatory Reality is divided into three parts.

Part One: Understanding the Immediate Political Reactions

Part One examines the broad, immediate reactions of policymakers and regulators as the crisis unfolded in 2008 in the United States and around the world. Chapter 1 outlines the events that resulted in the enactment of the Emergency Economic Stabilization Act of 2008, which helped to stabilize the immediate impact of the Great Financial Panic.

Chapter 2 then explores the global reaction, which culminated in the unprecedented Group of Twenty (G20) meeting of world leaders in Washington, DC, to rebuild a new international financial regulatory regime.

Chapter 3 offers my reflections on the beginnings and initial implications of the new regulatory reality.

Part Two: Understanding U.S. and G20 Regulatory Reforms

Part Two focuses on the impact and fallout of the legislation proposed by the Obama Administration and enacted by the U.S. Congress in 2010, almost two years after the immediate reaction of EESA. Chapter 4 details the actions of the U.S. Congress to pass the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; in Washington, DC, the legislative process is just as important as the legislative substance.

Chapter 5 then examines the new Dodd-Frank Act along four major dimensions: (1) the new regulatory architecture, (2) "more stringent" prudential standards that "increase in stringency," (3) new operating restrictions, and (4) higher regulatory costs.

Chapter 6 presents an update on the direction of the G20 process as it provides continuing policy and political guidance to the financial regulators and international standard setters.

Part Three: Preparedness: 10 Lessons for Winning in the New Regulatory Reality

Finally, Part Three offers 10 practical, commonsense lessons primarily for financial institution managements and boards, which have to manage and try to win in their new regulatory reality. Let me offer the "headline" thought of each chapter below.

Chapter 7, "Set the Right 'Tone at the Top,'" examines the leadership that regulators increasingly will demand by both boards and senior management in the new regulatory reality.

Chapter 8, "Tell a Good Story," discusses the urgent need to have a good story to tell all stakeholders, not just investors and employees, and then communicate it as part of continuing education efforts about the role of financial intermediation in society.

Chapter 9, "Be Politically Adept, Not Tone Deaf," addresses a practical approach to issues like executive compensation and consumer protection given the current political reality.

Chapter 10, "Advocate Constructively for Better Outcomes," reviews the fact that good public policy can only flow from constructive policy engagement among policymakers, regulators, and the industry; bad public policy can be bad for consumers, business, and the economy.

Chapter 11, "Manage Strategy and Regulatory Risks Together," stresses the need to fully align the management of unique regulatory risks in the financial services industry with corporate strategy.

Chapter 12, "Maintain Fortress Strength at All Times," recognizes that balance sheets and profitability separate winners from losers in a financial crisis; it's always better to be a winner, especially in the combined new world of Basel III and the Dodd-Frank Act.

Chapter 13, "Live Good Governance," emphasizes that good governance pays dividends, and regulators increasingly will demand good governance by both management and boards.

Chapter 14, "Plan Carefully for Contingencies," examines the critical need for credible contingency planning in good times, even though the new rapid resolution requirements are likely to be a necessary but largely unproductive exercise for well-capitalized, well-managed companies.

Chapter 15, "Engage Regulators on Warning Signs," addresses the importance of working with regulators to discover early crisis warning signs and potential systemic threats, and then pay attention to them before it's too late.

Chapter 16, "Build Trust-Based Relationships with Supervisors," reviews the importance of rebuilding trust with regulators and offers some practical, commonsense steps that can be started on Monday morning without waiting for new rules.

Chapter 17, "Conclusion–Be Prepared," is the concluding chapter and ties the implications of the 10 lessons together for both individual financial companies and the industry.

A

The reality of the final reform legislation is no less than a complete and fundamental revolution in U.S. financial regulation. Consequently, it will force senior managers in financial institutions to alter not only the way they compete and serve their customers, but also manage their firms' risks—including the specific new risks arising from their own—in some cases self-inflicted—regulatory reality. Not surprisingly, this new reality is likely to force policymakers and regulators to adjust their thinking as well, particularly in a stagnant economy that faces other near-term risks, such as a looming fiscal crisis.

Based on the political and policy aftermath of the financial crisis and the new mandates in the United States and around the globe, financial firms should assume that regulators and supervisors will be more active and aggressive than at any time in recent memory. The days of regulators standing on the sidelines while companies created new products, entered new business lines and markets, and booked higher and higher amounts of risk on their balance sheets without the requisite attention and management of those risks are over. No longer can boards and management teams assume that compliance officers can manage all the new regulatory risk at their levels alone.

To be successful commercially in the new regulatory reality of the foreseeable future, management and boards will need to relearn and fully understand the lessons coming out of this crisis before the next crisis hits. Despite every attempt in history, no amount of financial reform and regulatory overhaul, however well intended, will stop the next financial tsunami. Yet you can take steps now to prepare for the next significant market disruption, even if we can't perfectly predict how or when or in what form it will strike.

I thought we would have learned this after the U.S. S&L crisis, and especially after the Asian financial crisis a decade later. Yet another decade after that last crisis, here we are again. I hope this book gets individuals in critical positions in their companies and the industry to first reflect and then think ahead so we don't experience another shock of comparable financial and socioeconomic destruction any time again soon.

AS YOU BEGIN

Since the new U.S. law just passed in 2010 and the regulations are just now starting to emerge as this book is being released, *Managing to the New Regulatory Reality* should be considered simply as work in progress. I have tried to convey a realistic and comprehensive view of this new regulatory reality as I anticipate it will develop, including its major moving parts and

their practical consequences. I offer new lessons to consider when responding, hopefully enabling financial institutions to rise above the new political challenges and regulatory burdens to compete anew from a stronger platform and serve customers even better in the future.

Only time and a bit of luck will tell if I have hit or missed my mark. Remember, it's better to be a winner, so be prepared before the next crisis strikes.