# Regulators Address Continuing Uncertainty and Lessons Learned from the Crisis

••Continuing uncertainty and lessons learned from the recent crisis were addressed by senior financial regulators and a senior industry consultant at a recent New York Chapter event. The views expressed by the individual regulators and the consultant are their own and do not reflect the view of their respective agencies or organizations.

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BY KATHLEEN M. BEANS

REGULATORY UNCERTAINTY CONTINUES to plague the financial services industry as firms wait for Dodd-Frank Act rules to be written. At a New York Chapter meeting in February, a panel of regulators and a bank regulatory consultant addressed possible impacts, expectations for boards and management, international coordination, and lessons learned from the recent crisis. The discussion was moderated by Susan D'Andrea Lee, a New York Chapter governor and senior principal of Promontory Financial Group.

Grace Vogel, executive vice president, member regulation, Financial Industry Regulatory Authority (FINRA), said most of the regulations resulting from Dodd-Frank are revolutionary rather than evolutionary.

"We have probably 80 years of rule making on the securities side, and it seems like within a very short period of time—two to three years—we're trying to take everything from the security side and replicate it on the derivatives side. It's going to be a challenge for everyone," she said.

Among the challenges Vogel cited are the execution of derivatives on swap execution facilities (SEFs), clearance through derivatives-clearing organizations, trade reporting, and sales practice rules around derivatives.

Carlo di Florio, director, Office of Compliance Inspections and Examination, Securities and Exchange Commission, agreed, noting that derivatives and swaps are undergoing a tremendous shift in regulatory focus and will require a great deal of attention and resources. He also said that the entirely new regulatory framework for credit rating agencies impacts all financial institutions. Under Dodd-Frank, the SEC needs to conduct exams of credit rating agencies every year around eight prescribed areas, plus any other areas it believes are high risk.

Marc Saidenberg, senior vice president, Financial Institution Supervision Group, Federal Reserve Bank of New York, takes a broad view of regulatory reform. "Do you know how your business models are going to evolve in response to regulatory reform?" he asked. "It's dangerous for regulators to think that we can adequately anticipate their clients in connection with other lending activities. The *de minimis* exemption would exempt an entity from being a swap dealer if it had a notional amount of transactions or a number of clients within a 12-month period that fall below established thresholds. These entities won't know if they are a swap dealer until these definitions are finalized."

Harris also said there's a broad class of instruments for which the industry doesn't yet have guidance, such as risk participation agreements and stable value protection agreements. "If these instruments are found to be swaps, then a number of entities that don't currently think they are swap dealers may, in fact, become swap dealers and have to register," he said.

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Gary Barnett, director of the Division of Swap Dealer and Intermediary Oversight, Commodity Futures Trading Commission, agreed with Harris about the impacts, but said the regulators will provide guidance when the rules come out. He noted, however, that the rules would not provide hard lines specifying what is allowable. Further interpretation, based on their specific facts, will be required in some cases, and he explained his plan to target strategic examples for interpretation in order to provide guidance as efficiently and promptly as possible.

or assess the industry's preparedness for regulatory reform without the industry having a deeper understanding of how the business practices are going to evolve.

"It would be a mistake to think this is largely a compliance exercise," cautioned Saidenberg. "We cannot evolve back to 2005 business as usual."

He said the supervisory model must evolve along with regulatory expectations. A major lesson from the crisis is that regulators need to be effective overseers. "We need to understand the business model, the strategy that sits behind what drives the organization and the business practices so that we can make sure that we understand the vulnerabilities associated with that business model. We need to ask, what is it about the nature of the business, the nature of the business strategy, that could lead to vulnerabilities?"

Doug Harris, managing director, Promontory Financial Group, said some regulations could greatly impact his firm's clients. The Volcker Rule, for instance, would impose a cost burden on firms that are active in proprietary trading, as well as many firms that are not currently active. "It's going to require monitoring for certain compliance metrics," he said.

Harris also is concerned about definitions of a swap dealer, a major swap participant, and eligible contract participant, for which the Commodities Futures Trading Commission (CFTC) and the SEC are devising legal definitions. "Whether a firm falls within that definition is going to be important in terms of their ongoing business model, the compliance programs they have to put in place, and the risk management programs they have to put in place."

It's especially important for some of the smaller banks. "Large banks know they are going to be swap dealers, and they know they are swap dealers in a number of different products," Harris said. "Regional banks are unsure. They may be able to take advantage of the IDI exemption for depository institutions that engage in swaps activities with

## Senior Management and Board Roles

Di Florio advises the board and senior management to prepare to meet new regulatory requirements by making sure:

- Business strategy is defined.
- Risk appetite and tolerances are considered around critical objectives.
- The board is confident that senior management has developed a strategic plan that addresses the new regulatory framework.
- Business units have been reviewed in terms of the new environment.
- Risk and control functions provide objective monitoring and oversight.
- Internal audit functions provide independent assurance with the control environment around the new regulations.
- Risk management requirements are effective.

Harris, a former OCC regulator, said all new policies and procedures developed to comply with the provisions of Dodd-Frank should go to the board initially, even if they are later approved by others in the organization.

FINRA's jurisdiction is limited to broker-dealers, and Vogel advises boards to understand the risks that new businesses or products introduce and to be sure proper controls are in place to manage them. Boards of firms that had sizable portions of earnings from proprietary trading need to understand the impact of lost earnings on revenue and profitability.

It is critical that senior management and the board understand the incentives that were created by the presence or absence of regulatory reform in certain areas, said Saidenberg. "The failure to understand the incentives that are created either by the regulatory environment or the market environment is very wrong."

Doug Harris, Promontory Financial Group

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Saidenberg added that the management team must own the strategy. "If we look to regulations or Basel to determine the obligations of the board of directors, we will critically understate their obligations—not to us as supervisors, but their obligations to their shareholders."

### Risk and Compliance Functions at the Fed

"The last few years we've slowly started to come up for air," said Saidenberg, noting that regulators have been trying to determine the lessons from the past five years in the context of regulation and supervision. They've learned both from what they didn't do as well as what they did do during the crisis, and they are making decisions that are informed by these four perspectives:

1. How vulnerabilities emerge at individual firms.
2. How vulnerabilities differ across a set of firms.
3. An independent view of vulnerabilities that is not solely informed by the risk analysis of the firms.
4. Supervisory standards.

"We will never have the capacity to look at everything," said Saidenberg. ""We've tried to come up with a lens that doesn't prescribe what we do, but informs how we spend our time. We have to focus on areas where our perspective, as supervisors, may differ from the commercial perspective.

"Hopefully, we can be helpful to the industry in understanding emerging or better practices. Fundamentally, that's a matter of you wanting to manage yourselves better. That's where our interest and your interest are perfectly aligned. It's more difficult when your interests and our interests are not perfectly aligned either because we have a different risk tolerance, or because we have a view of what is socially or publicly appropriate as opposed to what is commercially beneficial."

### Adapting to the new Supervisory Framework

Barnett pointed out that some large institutions have already allocated people and resources for Dodd-Frank, while other institutions continue to hold back as they await product and swap definitions, or at least until the implementation timeline gets closer. The new chief compliance officer requirements and the new emphasis on internal business conduct rules will represent a qualitative change in the way the CFTC-regulated entities, including futures commission merchants (FCMs), will run their businesses and how the CFTC will assess and examine them.

Promontory's Harris believes the industry is in various stages of preparedness for the Dodd-Frank regulations. Some of the larger institutions have a Dodd-Frank Act implementation committee and a number of work streams consisting of staff from the important risk management control functions and front offices working together to ensure that they're ready for compliance.

Many regional banks are taking a wait-and-see approach. "They want to be absolutely sure they're going to have to make these changes before putting new policies, procedures, and organizational changes in place," said Harris.

Among foreign banking institutions, Promontory is seeing a lack of preparedness for a combination of reasons:

- The CFTC and the SEC have yet to provide strong guidance on the issue of extraterritoriality and the extent to which the provisions of Title VII will impact their non-U.S. operations and, to some extent, their U.S. operations.
- The lack of guidance on extraterritoriality is complicated by the status of inter-affiliate transactions, which is also an issue for many U.S. institutions, particularly with derivatives.
- The push-out provision, which prohibits federal assistance to an entity registered as a swap entity, is a great concern of foreign banks. U.S. banks were excepted from the push out with respect to derivatives on certain bank-eligible asset classes such as rates, currencies, and precious metals. Foreign banks aren't able to take advantage of that exception.

### Enterprise Risk Management

According to Di Florio, some of the regulatory changes are substantive, some structural, and some cultural. On the substantive side, CROs have been trying to identify program gaps, particularly in the traditional market risk, credit risk, operational risk, and compliance risk model. Liquidity in funding stood out as an area that needed a lot more attention than it had leading up to the crisis. ERM functions are focusing on discrete areas.

In the business units, there's an emphasis on effective stress testing and oversight at the product and asset class levels. From a structural perspective, firms want a holistic risk management program that encompasses the risk governance framework. Many boards focus on whether they have effective expertise and skill sets, and if they need a discrete risk committee, for instance. Senior management teams have looked at the committee structure to determine if there's a better way to bring risk and financial and compliance information together and to better report it.

Internal audit has spent a lot of time thinking about how to more effectively audit risk and give some comfort around control environment effectiveness.

Culturally, regulators want to see an appropriate collegial tension between risk management and the business. Many organizations had great committees on paper and all the right people, but when a critical decision was being made on a product or a strategy, or about risk appetite or risk tolerance, the business voice carried the day and the risk management voice was somewhat muted. Regulators want to see an independent authority for risk management.

## Lessons Learned

The importance of controls, transparency, liquidity, and capital was a lesson of the recent crisis. Harris said the recent problems at MF Global highlight the importance of robust internal controls, including proper segregation of duties.

"If the CEO, who is a trader, has the ability to fire the chief risk officer because he's unhappy with his advice, then you don't have proper segregation of duties," he said.

Harris said no controls can prevent fraud, but you can put in place controls that will help you detect fraud more quickly and mitigate the losses that result.

Another lesson is the need for greater transparency around transactions, positions, and risk. Harris said better public disclosure with respect to FCMs and their customer segregated funds will develop as a result of the MF Global failure.

Di Florio said the recent crisis is a reminder that liquidity is key: "It can go so quickly and it can be driven by various factors." Before a crisis occurs is the time to think about customer protection and the implications of some operational challenges that may arise within an organization. These challenges could include data, clearing, understanding books and records, and getting a true, transparent picture of the organization.

Vogel said it all comes back to capital. "When times are good, firms argue that they have plenty of excess capital and don't need it. No one can have enough capital. It needs to be there in good times. We don't want counter-cyclical regulations."

## Coordination among Agencies

The regulators are collaborating to achieve consistency in enforcement around Dodd-Frank rules. Barnett talked about the information sharing that has been going on among CFTC and SEC teams on some very complex issues over the past year. He cited the concerted effort to achieve consistency, where possible, giving as an example the fact that the SEC and CFTC have different statutes controlling their respective cross-border analysis. Beyond rule making, oversight will require a lot of coordination.

"We've got to break down silos on the regulatory side just as we're looking for institutions to break down silos on the industry side," said Di Florio.

Achieving uniform rules is challenging. For example, CFTC and the SEC are both regulators for dually registered broker-dealers and FCMs, so together they need to find solutions that fit both the futures model, which is typically a broker model, and the dealer model.

"It's the agency versus principal and it's a different mentality," said Vogel.

Harris noted that achieving consistency is an international issue as well. "From the financial institution perspective, consistency among Europe, the U.K., the U.S., Asia, Australia, and Canada will benefit the market. Lack of consistency presents an opportunity for regulatory arbitrage, and it also increases the cost of doing business," said Harris. "Without consistency, institutions would have to adapt to different systems, different technologies, and different policies and procedures to do the same kind of business in different places."

Saidenberg added that there are differences in the regulators' expectations around stress testing being applied to institutions because different institutions have different risk profiles and different degrees of complexity. "One size won't fit all. It's going to lead to differences," he said, but added that if the difference can be justified by either the regulators' responsibilities or the risks that they're trying to assess, then the differences are appropriate.

Many lessons were learned in the recent crisis, not all of them new. "I've been in the business long enough to know these lessons repeat themselves," said Vogel. "The industry has a short-term memory. We need to know that the next time it's going to be a little bit different, but the basic premises will likely be the same." ❖

***Kathleen M. Beans*** *is editor of* The RMA Journal. *She can be reached at* kbeans@rmahq.org.