



POST-DAVOS REPORT: Regulatory-Risk Strategic Assessment

As financial markets continue their wild gyrations, bank, securities and insurance regulators are well aware that recent developments have uncovered gaping holes in the current regulatory framework and plans are already under way to shore these up. Some changes will come from high-profile enforcement actions by regulators or U.S. law enforcement, uping reputational risk in the short term. However, regulators are well aware that enforcement actions alone cast a short shadow. They are thus laying the groundwork for far-reaching structural changes. In this alert, we highlight key issues and forecast likely action on them.

NOTE: Federal Financial Analytics does not suggest that any of the policies noted below is necessary or appropriate. This analysis presents our objective assessment of likely initiatives.

CAPITAL

Key developments here include:

- a rewrite of the Basel II credit- and market-risk rules to reduce reliance on credit ratings agencies and monoline insurance. New asset correlation requirements are in the works, along with capital incentives for additional credit risk mitigation. Calls in the U.S. for a new leverage standard applied world-wide will gain new credence;
- quick action on regulatory-capital requirements in asset securitizations. These will replace the “true-sale” approach that permits complete elimination of issuer regulatory capital with new standards that impose capital and, it is hoped, discipline; and
- new liquidity-risk capital standards, buttressed by new requirements for valuation reserves. Express concentration-risk standards are also in the works.

U.S. bank, securities and insurance regulators will work at the outset to set rules in tandem and on a schedule consistent with international action, hoping to limit – if not terminate – regulatory-capital arbitrage. U.S. insurance companies will come under more pressure from federal regulators and Congress to adopt a capital framework comparable

to Solvency II. In addition, market-discipline disclosures along the lines recently proposed for large U.S. banks under the advanced Basel II options may be adopted for all financial institutions that present systemic-risk potential.

INCENTIVE ALIGNMENT

In addition to new capital standards for securitizations designed to align issuer incentives with those of investors, an array of additional measures is under consideration including:

- evaluation of executive compensation, with possible use of U.S. regulatory authority over management compensation to mandate additional board scrutiny of bonuses and related arrangements;
- changes to align trader compensation with long-term shareholder interests;
- mandates for higher-level risk management independent of line units. This would include direct board access for internal risk management analogous with that now accorded internal and external audit; and
- new legal risk for securitizers, sponsors of mutual funds and fiduciaries to require additional care in selecting investments for third parties.

RISK MITIGATION

The collapse of some of the big monoline bond insurers has shocked global regulators. Changes in response include review of a possible federal rescue. This would be highly controversial and would come at the cost of significant new insurance-industry regulation and, perhaps, a new federal charter. Overall review of credit risk transfer will also require reliance on well-capitalized credit-risk counterparties to which risk assignment can be clearly traced and legally enforced.

MERGERS & ACQUISITIONS

Bank regulators have taken a far more stringent view of non-traditional acquisitions than in the past. Although these restraints will be loosened for acquisitions of troubled banks, they impose significant new costs on other transactions. Regulatory actions include:

- requirements that non-traditional acquirers provide a “source of strength” to insured depositories;
- FDIC holding-company style governance of parents of industrial loan companies;
- new SEC standards to govern the parent companies of broker dealers; and
- additional capital requirements, regardless of the nominal capital rules in place, to add capital addressing the proposed business plan.