

Regulatory Reform: Planning for Change

Introduction

On May 20, 2010, the Senate approved a far-reaching financial regulatory reform bill, putting Congress on the brink of approving a broad expansion of government oversight of the increasingly complex banking system and financial markets. This expansion of oversight may include the following changes:

- Regulators would receive more authority to monitor a broad range of products, from mortgages to complex securities
- Financial firms would be forced to reduce financial leverage and to hold more capital in reserve
- Derivatives would be subject to new regulations, where most trading would be required to take place through open marketplaces
- A new consumer protection agency would be created with powers that include curbing abusive lending, particularly in the mortgage industry

This article provides a brief overview of potential impacts that could result from enactment of this bill and offers some suggestions on what banks can and should do to prepare for it.

Potential Impacts

The bill, if enacted, threatens to constrain the banking sector's future profitability – already constrained by recent economic events -- for years to come, and may create new demands for more conservative risk management. Potential impacts include:

- Reduced “top line” revenue due to increased pressure to lower rates and limit fees as a result of regulatory changes
- Constrained loan growth due to higher capital requirements
- Increased costs due to the need for more stringent oversight of risk management and measuring, monitoring and reporting of risk

What Banks Should be Doing to Prepare for Enactment of the Bill

In anticipation of this bill (or something close to it) being enacted, banks should undertake a self assessment to understand its implications and put contingencies in place.

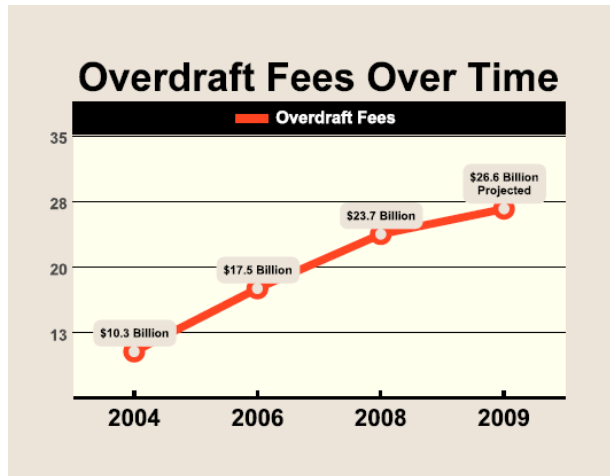
Potential steps banks could be taking immediately include:

1. Understand the magnitude of the potential impacts to the bank's top line revenue streams and loan growth opportunities that are at risk due to regulatory reform.
2. Identify the strategies that can be put in place that could minimize the potential impacts of constrained fee income and loan growth.
3. Determine how best to obtain customer input and feedback to validate the new strategies and redefine value propositions necessary to replace lost revenue.
4. Evaluate how costs can be managed relative to monitoring, managing, and measuring risk across customers, segments, products and business lines.
5. Identify what corporate measurements are most critical to monitor strategic and business performance and develop the capabilities needed to do so.

These steps are further explained below.

1. *Understand the magnitude of the potential impacts to the bank's top line revenue streams and loan growth opportunities that are at risk due to regulatory reform.*

The total impact of regulatory reform on banks' revenue streams has yet to be estimated. However, according to a 2009 Study conducted by the non-profit Center for Responsible Lending, it is estimated that banks generated approximately \$23.7 billion in overdraft fees in 2008, an increase of 35 percent over the past two years. In 2008, the FDIC found that nearly three-quarters of its banks' \$34.3 billion in service charge income was the result of overdraft and non sufficient funds fees. The Study used this breakdown to estimate that banks and credit unions assessed 69 percent of this total, or \$23.7 billion, in overdraft fees alone in 2008 and estimates that this will increase to \$26.9 billion in 2009.



Source: "Overdraft Explosion: Bank fees for overdrafts increase 35% in two years", Center for Responsible Lending, July 2009

A Sandler O'Neill & Partners report in May 2010 estimated that the two banks with the largest potential hit in annual revenue as a result from the loss of overdraft income are Bank of America (\$2.2 billion) and Wells Fargo (\$1.1 billion).

2. Identify the strategies that can be put in place that can minimize the potential impacts of constrained fee income and loan growth.

With pressure to lower rates and fees, banks may need to take a more aggressive approach to communicating value, reviewing pricing, developing new products and services and entering new customer segments. While there may not be a silver bullet to replace lost fees, there may be incremental strategies that collectively could protect and/or replace a large portion of them. For example:

- **Opt-In Strategies:** With the changes resulting from Regulation E, consumers will need to opt-in to retain overdraft protection. Having an aggressive opt-in campaign to explain the benefits of overdraft protection may cause many consumers to prefer to remain eligible for overdraft advances and the resultant fees.
- **Pricing Changes:** Product pricing may need to be adjusted to reflect the new risk and regulatory environment. For example, "no fee checking" was made possible largely as a result of the insufficient funds and overdraft charges levied on these accounts. Absent some portion of this revenue, banks may need to consider adding monthly fees to help replace lost income. Bank of America announced in June 2010 that it is dropping nearly all of its overdraft programs and replacing them with a variety of new

products with different pricing structures to encourage the customers to increase banking activity or use other products or as a way to replace fee income. Wells Fargo is ending its free checking product in July 2010.

- **New Fee Based Services:** Adding new fee based services may also help offset some of the lost revenue. For example, aggressively offering pre-paid cards and mobile banking services could potentially generate incremental fee as well as float income.
- **Small and Middle Market Business:** As the prospect of a new consumer protection agency takes shape, developing products and services aimed at small and middle market business customers may provide better revenue replacement and growth opportunities than targeting consumer segments.
- **Unbanked and Under Banked:** The FDIC's December 2009 study on unbanked and under banked households estimated that 23% of existing deposit customers use non-bank providers for their basic financial transactions. Seeking ways to capture some of that business away from non-bank providers would add more revenue to the banking industry.
- **Strategic Cost Management:** With the likelihood of continued downward pressure on revenue, banks will need to look at numerous options to maintain profitability. Strategic Cost Management is certainly one option to consider. Traditional approaches to cost reduction and cost containment have tended to be undertaken within organizational silos. Using a strategic cost management approach to assess customer-facing and support functions at both the enterprise level and across end-to-end processes may open up new opportunities for managing costs further.

Making judgments and decisions around strategic options similar to those identified above will require careful analysis. Important components of that analysis are likely to include: customer segmentation and target markets; portfolio considerations about products and services offered, and the customer experience to be delivered; segment, customer and product profitability; and, the qualitative and quantitative business case for executing the proposed strategy.

Moreover, with higher capital requirements, banks will need to carefully monitor their capital position and be increasingly selective about how that capital is deployed. Developing timely, comprehensive and forward-looking metrics will be critical to monitoring the bank's capital position. Understanding the capital required for planned strategic initiatives and the expected risk-adjusted returns on that capital, and determining the resulting priorities on how that capital should be deployed will become a more significant part of the strategic planning process.

3. Determine how best to obtain customer input and feedback to validate the new strategies and redefine value propositions necessary to replace lost revenue.

In developing new products and services to make up for lost revenue, banks would be wise to create mechanisms to gain timely customer feedback and potentially avoid investing capital in concepts that may have low adoption rates. For example, Bank of America is testing new pricing models in an attempt to make up for lost revenue resulting from the changes to overdrafts fees.

The Bank intends to give customers a choice between increasing its activity, for example, bringing more accounts into the relationship, maintaining higher balances, using credit cards, or using investment advisers or accepting monthly or periodic maintenance fees. Utilizing a feedback loop that obtains information about customer preferences and analyzes customer behavior, for example, through an online forum, will provide the Bank of America with information to help refine its pricing models to each of its customer segments. This will allow them to expand the testing to full roll-out if the results meet expectations or modify pricing structures by customer segment to gain the highest adoption rates.

One inexpensive way banks are obtaining timely customer feedback is through its web site. Providing an online forum to gain feedback about testing products or pricing models can assist banks refine their plans prior to a full scale launch. American Express uses a site for promoting its pilot programs to obtain customer feedback among other purposes.

4. Evaluate how costs can be managed relative to monitoring, managing, and measuring risk across customers, segments, products and business lines.

With a heightened regulatory focus on risk management, banks will need to look at their overall risk profile as well as their risk management practices across the enterprise, and be much more transparent about them (not only to regulators, but to customers as well). Clearly, "siloesd," product-focused risk management practices are incapable of capturing enterprise-level risks accurately when customer relationships span multiple accounts and product silos. This can be particularly true when customers have both business and consumer accounts and when business customers have multiple related entities.

Being able to link, view, and manage customer accounts across all lines of business would allow banks to take a more holistic view of, and proactive approach to managing overall risk exposure. Use of advanced data analytics, such as business intelligence tools are a cost effective way of managing enterprise-wide risk.

For example, in the case of operational risk management related to check kiting, banks have tended to look at account risk, rather than customer risk. Exceptions are reported at the account level and, typically, banks have different lines of business that review checking account exceptions for retail accounts than the one that reviews exceptions for business accounts. Providing a mechanism that allows for the viewing of accounts at a customer level could provide greater insight into the full extent of risk exposure to check kiting.

A similar situation can be found with credit risk. For example, when a small business owner has both a consumer or residential loan and a line of credit for the business, accounts can be serviced and managed by multiple business lines. Again, providing a capability to view customer risk along with account risk would provide greater insight into overall credit exposure of the customer. Another common gap in managing credit risk can be found where co-borrowers are involved in multiple loans. In many banks, the aggregate exposure with co-borrowers is overlooked. In this case, managing customer risk would provide greater insight into managing overall risk, than managing risk at the account level.

5. *Identify what corporate measurements are most critical to monitor strategic and business performance and develop the capabilities needed to do so.*

Banks should not presume their current strategic drivers will be sound in the new regulatory and competitive marketplace. With a change in the rules governing the financial marketplace, some of the drivers of success and associated metrics are also likely to change. For example, to drive and monitor revenue replacement efforts, banks may want to develop and track new measures around product innovation. Understanding these drivers in context of the other corporate performance management measures will enable decision makers to balance the organization's focus across competing influences. Just as it is imperative that banks review their strategic options in the changing financial services environment, it is equally important that banks develop new measures aligned with any new strategic direction or initiatives and put in place the infrastructure to report on those measures. Incorporating these measures into the cadence of existing measurement and monitoring processes (e.g., a

monthly strategic scorecard) will help drive accountability for, and generate valuable feedback, on the success of these initiatives.

In Summary

With the inevitable passing of some type of financial regulatory reform bill, banks will need to assess the potential impact that such reform might have on their strategies, operations, reporting and financial results. Banks that conduct a self assessment before that reform is enacted and proactively develop plans to comply with its requirements and minimize its impacts will be well-positioned to move forward successfully into the brave new world of banking.

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