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Assessing and addressing the implications of new financial regulations for the US banking industry

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Contents

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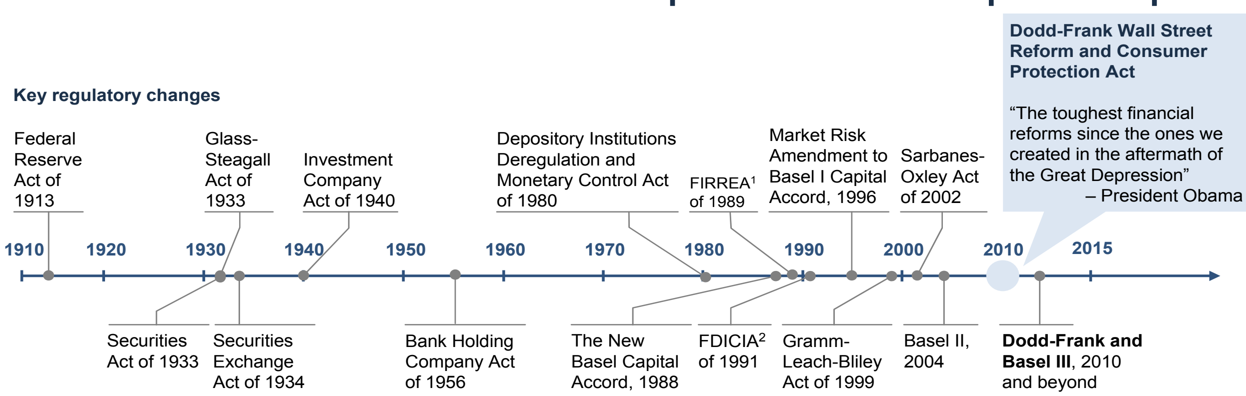
Assessing and addressing the implications of new financial regulations for the US banking industry

Executive summary [1]

The Dodd-Frank Wall Street Reform and Consumer Protection Act, together with the rigorous capital and liquidity standards defined by the Basel Committee (Basel III), represent the most sweeping expansion of regulation for US financial institutions since the Great Depression (Exhibit 1).

Exhibit 1

Dodd-Frank and Basel III reforms are unprecedented in scope and depth



	1913	1933	1934	1940	1956	1980	1988	1989	1992	1996	1999	2002	2004	2010
Regulatory structure	✓					✓		✓	✓					✓
Capital standards							✓		✓	✓			✓	✓
Securities/banking			✓	✓							✓			✓
Traditional banking						✓		✓						✓
Consumer protection		✓	✓	✓		✓					✓	✓		✓
Permissible banking activities		✓			✓	✓		✓	✓		✓	✓		✓

[1]Financial Institutions Reform, Recovery, and Enforcement Act of 1989.
[2]Federal Deposit Insurance Corporation's Improvement Act of 1991.

These requirements have the potential to reshape the business of banking dramatically during the coming years by changing the oversight structure for all financial institutions; adding new restrictions on products; significantly increasing capital, liquidity, and corporate governance requirements; and placing additional levies on financial institutions.

1 This memorandum by McKinsey & Company's Risk and Strategy practices focuses primarily on the impact of the Dodd-Frank Act on the US banking sector, and is based on a July 27, 2010 memorandum shared with clients. However, many of the implications apply to non-US institutions as well as US-based nonfinancial firms, especially those that are designated for enhanced oversight.

In this paper, we discuss how these regulations are likely to affect business models and introduce six dimensions along which banks are likely to respond:

- **Evaluate business strategies and operating models after the impact of regulation.** Several businesses—capital markets (including over-the-counter (OTC) derivatives and securitization), proprietary trading, debit and credit cards, and checking—are explicitly affected; others, including mortgage lending, are also implicated and should be reviewed.

- **Optimize capital and liquidity management.** Banks should enhance the frameworks and processes used to manage economic and regulatory capital, minimize capital waste across all businesses, and redefine business models for efficient capital usage.

- **Broadly upgrade risk and regulatory compliance capabilities.** We see four actions here: strengthen dynamic risk reporting capabilities, finish the automation of risk management and regulatory compliance processes, institutionalize stress-testing and use it to set risk appetite, and simplify legal entity structures.

- **Manage costs even more aggressively.** The new rules may result in direct implementation costs of over $100 million for the largest US banks, in addition to the likely diminishment of returns. Banks can respond by managing costs in each business line and by reevaluating the costs of corporate center and support functions.

- **Ensure that internal culture and processes reflect "customer-first" themes.** Financial institutions may find that building a culture that meets the spirit of the "customer-first" themes of the legislation can help mitigate some of the associated risks with the new legislation (in particular among frontline employees).

- **Accelerate the approach for integrating the implementation of new regulations.** Many of the crucial details of the new rules will be worked out over the coming two years. Banks should establish a formal project management team to ensure ongoing compliance with new requirements and the increasing volume of regulatory requests.

The new regulation and its implications

According to the Financial Services Roundtable, the 2,300-page Dodd-Frank Act mandates more than 200 new regulations and 67 studies and reports to be conducted by regulators over the next two years. The resulting legislation could translate into an estimated 15,000 to 20,000 pages of new rules and compliance requirements for financial institutions.[2]

Although many requirements have yet to be specified, the provisions of the Dodd-Frank Act fit broadly into five categories:

- **Expanded regulatory oversight of financial firms:** The Act restructures the regulatory landscape and assigns new oversight responsibilities to federal regulators in order to provide regulators with a macro-perspective of emerging systemic risks, the authority to manage threats arising from the financial sector, and the ability to regulate potentially abusive consumer financial products

- **New operating restrictions on financial activities,** including limits on proprietary trading and OTC derivatives, interchange fee limits and mandatory retention of at least 5 percent of many securitizations (qualified residential mortgages excepted)

- **Increased mandates for firm governance,** including new risk management requirements for annual stress tests, rapid resolution plans to facilitate the orderly liquidation of large failed institutions, increased public disclosures and investor protections, such as shareholder votes on executive compensation

- **"More stringent" prudential regulatory standards,** including mandates for higher capital levels, narrower definitions of eligible capital, increased liquidity requirements, possible leverage limits, and contingent capital requirements

2 Key provisions of the Dodd-Frank Act are outlined in the Appendix.

- **Significantly higher regulatory costs for larger firms,** such as changing the assessment base for FDIC deposit insurance (which will increase assessments significantly for the largest US banks, all else equal), shared industry responsibility for the liquidation costs of large financial institutions and new fees to cover many of the costs of the legislation

Exhibit 2 provides more detail on each of these five effects.

Exhibit 2

Key provisions of Dodd-Frank and Consumer Protection Act for bank holding companies

Oversight of financial firms	A New oversight authorities over banks and nonbanks (FSOC, FRB, FIO)[1]; combination of OCC/OTS[2]
	B New Consumer Financial Protection Bureau to review pricing, products and to ensure no "abusive" practices
	C New monitoring and reporting of systemic risks, as mandated by Office of Financial Research
	D Broader oversight authorities (hedge/private-equity (PE) fund registration, credit-rating agency examinations)
	E New oversight for credit-rating agencies (annual OCR[3] exams); removal of federal rating requirements
Restrictions/controls on activities	F Higher prudential standards for large, interconnected financial institutions (eg, capital, liquidity, leverage, risk)
	G Interchange fees limited in proportion to transaction costs; merchant "steering" rights increase (Durbin amendment)
	H Proprietary trading prohibited and ownership of hedge/PE funds limited to 3% of Tier 1 capital ("Volcker Rule")
	I Increased supervision and restrictions on OTC[4] derivatives, including mandatory clearing requirements
	J Swap dealers required to push out derivatives such as CDS[4] and commodities into nonbank subsidiaries
	K Mandatory retention of at least 5% of securitizations; banks prohibited from hedging this retained risk
	L Reclassification of intercompany derivatives, repos, and securities borrowings as 23A loans (new limitations)
	M Banks allowed to pay interest on business checking accounts, repealing prohibitions of Regulation Q
	N New limitations for financial mergers (cannot exceed 10% of aggregate financial liabilities to limit systemic impact)
	O New requirement for mortgage lenders to ensure a borrower's ability to repay home loans
Governance mandates	P Specific risk-management requirements (mandatory stress tests, board risk committee)
	Q Rapid resolution plans required for large institutions to ensure orderly liquidation in case of failure
	R Increased public transparency and investor protections (including SIPC[6] and Sarbanes-Oxley amendments)
	S Executive compensation transparency and restrictions, including monitoring of pay vs. performance
Capital and liquidity standards	T Increased capital requirements and mandated capital increases as banks grow or engage in "risky" activities
	U Restricted definition of capital, including elimination of credit for Trust Preferred and other hybrid capital
	V Debt-to-equity leverage limit of 15:1 for institutions that pose a "grave threat to financial stability"
	W Potential introduction of contingent capital requirements (to be determined by FSOC study)
	X Inclusion of off-balance-sheet activities in the computation of capital requirements (to be determined by Fed study)
Levies / taxes on financial institutions	Y Change to FDIC assessment rate, particularly for large banks (eg, based on assets less tangible equity)
	Z Special assessments: FDIC[7], BHC[8] exam fees, FSOC, OFR[9], industry payment of future liquidation costs

[1]FSOC = Financial Stability Oversight Council; FRB = Federal Reserve Bank; FIO = Federal Insurance Office. [2]OCC/OTS = Office of the Comptroller of the Currency/Office of Thrift Supervision. [3]OCR = Office of Credit Ratings [4]OTC = over the counter. [5]CDS = credit default swap. [6]Securities Investor Protection Corporation. [7]FDIC = Federal Deposit Insurance Corporation. [8]BHC = bank holding company. [9]OFR = Office of Financial Research.

The changes mandated by the Dodd-Frank Act represent, in a number of cases, improvements over current industry practices in risk, capital, and liquidity management that are likely to make banks safer and more resilient. These include:

- **Improved governance and risk management** and a greater ability of individual banks to withstand future economic down cycles due to higher capital and liquidity levels

- **Potentially reduced vulnerability of the banking industry to systemic risks** due to lower aggregate leverage and higher liquidity buffers

- **Additional protections for consumers** from misleading financial products and services

- **Improved market transparency and efficiency** for investors due to more comprehensive broker-dealer regulation and enhanced rating agency accountability

- **Potential improvements in the stability of the macro economy** due to a reduction in the likelihood that a future financial crisis will exacerbate a broader recession

The provisions of the Dodd-Frank Act, however, could also give rise to a range of unintended consequences for US banks, financial markets, and consumers:

- **Decreased industry profitability** and financial flexibility may result from higher capital and liquidity requirements as well as increased regulatory costs for large banks and large nonbank firms designated by the Council as requiring "more stringent" prudential standards.

- **Potential shift of capital and business activity** from US banks to less-regulated firms in the United States or abroad (e.g., foreign banks—particularly in emerging markets, large asset managers, hedge funds and insurance companies). Several of the provisions within the Dodd-Frank Act go beyond the issues that the G20 has on its agenda and therefore may put US banks and financial markets at a competitive disadvantage in internationally competitive lines of business (e.g., the Volcker Rule on proprietary trading, OTC derivatives limitations, and clearinghouse requirements).

- **Potentially decreased credit availability** for consumers and small to midsize enterprises (SMEs), including reduced appetite for banks to introduce new products, particularly for segments with historically poor credit performance. This decreased credit availability has the potential to moderate the long-term growth rate of the overall economy, particularly if the changes result in higher costs to businesses and consumers.

Additionally, we anticipate a number of potential long-term strategic implications of the Dodd-Frank Act and Basel III reforms for the US financial services industry:

- **Heightened focus on traditional banking activities,** such as direct consumer and business lending and an increased reliance on branch networks and relationship banking

- **Increased specialization** as portions of the value chain, such as funding for complex mortgages and proprietary trading, shift to niche nonbank providers. By requiring separation or separate capitalization for proprietary trading and complex derivatives, the Dodd-Frank Act removes much of the natural diversification embedded in bank product portfolios. This may reverse the trend during the past 20 years or so, during which universal banks became the natural owners of adjacent financial businesses by virtue of their lower funding costs and opportunities to leverage debt. In the future, it may be more capital-efficient for certain businesses to operate independently—or at least with nonbank partners

- **Accelerated consolidation among banks subject to the new "more stringent" standards,** where permitted by regulators. For example, mid-tier banks with assets of $50 to $100 billion may initiate a new round of consolidation to compete with the largest banks, which face similar regulatory requirements under the Dodd-Frank Act, while banks below the $50 billion threshold may be less likely to merge if the resulting firm would be subject to the new prudential standards

Key actions to consider in response to the new regulatory environment

In this section, we discuss six dimensions of action US financial institutions could consider intensifying in their response to the Dodd-Frank Act and Basel III. (Exhibit 3)

1) Thoroughly evaluate the strategies and operating models of businesses

While the Dodd-Frank Act is likely to have implications for most lines of business in terms of capital and funding requirements and rising regulatory compliance costs, it includes provisions that affect certain businesses more significantly by changing revenue models, altering value propositions to customers, or modifying cost structures. We believe that financial institutions engaging in the following business lines may have the most to gain by accelerating their preparation for the new regulatory and competitive landscape:

- Capital markets, including OTC derivatives and securitization

- Proprietary trading

- Debit and credit cards and checking

- Other business lines where the combined impact of multiple provisions is sufficient to warrant a thorough review of the strategy and operating model (e.g., mortgage lending)

Exhibit 3

Dodd-Frank may require financial institutions to make fundamental changes across six dimensions

1 Thoroughly evaluate the strategies and operating models of businesses after considering the impacts of the new legislation	▪ **Assess the pro forma impact of the legislation** across the income statement and balance sheet for each business line and customer group ▪ **Revise the approach to businesses specifically affected by the reform**, for example by refining the revenue model, including pricing, or altering the value proposition to the customer – Specific businesses impacted by Dodd-Frank include debit/credit cards, proprietary trading, securitization, OTC[1] derivatives, and mortgage lending
2 Optimize capital allocation, capital management, and liquidity management in response to increasing regulatory requirements	▪ **Reallocate capital to businesses according to risk-adjusted profitability** by further enhancing the processes used to manage economic and regulatory capital on a granular basis and incorporating capital allocation into business processes such as performance measurement ▪ **Reduce trapped liquidity pools and reallocate liquidity** by redesigning the funding approach to surpass the new requirements, for example by estimating LCR[2] and NSFR[3] and incorporating liquidity into stress tests
3 Broadly upgrade risk and regulatory-compliance capabilities to effectively and efficiently meet increased requirements	▪ **Integrate required risk-management changes** in a way that genuinely improves the organization's ability to manage and mitigate its risk, focusing on: – Developing a robust and dynamic approach to stress testing across multiple stress scenarios – Implementing comprehensive risk reporting, including real-time mapping of consolidated exposures for rapid resolution plans – Streamlining legal structures in the context of Dodd-Frank
4 Manage costs even more aggressively to compensate for the increasing regulatory requirements and anticipated declines in revenue	▪ **Eliminate, streamline, or distribute costs**, for example, by rationalizing business-line costs, including compensation; by automating manual processes; or by passing costs to partners/customers ▪ **Reevaluate expenses in the corporate center and support functions** to ensure that the overall cost structure is appropriate for the new environment
5 Ensure that the internal culture and processes reflect the "customer-first" themes embedded in the legislation	▪ **Take real and persistent action to ensure that the organization's culture and internal processes incorporate the new consumer and investor protections** embedded throughout the legislation. – Key dimensions of internal culture include training and compliance, tools for compliance, incentives, and management role modeling
6 Accelerate the approach for integrating and coordinating implementation of the new regulatory requirements	▪ **Establish a regulatory response team to coordinate and implement changes rapidly** as the requirements are finalized and to respond to the increasing volume of regulatory requests – The response team should leverage project leaders from across business lines and functional areas, as well as senior management

[1] Over the counter; [2] Liquidity coverage ratio; [3] Net stable funding ratio.

Capital markets, including OTC derivatives and securitization

Changes to OTC derivatives and securitization rules will benefit less vertically integrated businesses

As noted earlier, certain OTC derivatives will be subject to central clearing requirements and possibly higher capital requirements. Mandated central clearing will reduce differentiation among providers based on creditworthiness, while increasing differentiation based on execution and service, since the clearinghouse will effectively eliminate counterparty credit exposure for clearinghouse members. This requirement may represent a significant opportunity for clearinghouses and may eliminate the perceived counterparty credit advantage currently held by large banks.

To react to these changes, financial institutions with trading businesses may wish to consider several options:

- **Focus on core strengths by becoming more specialized providers of trading services** where they have existing customer relationships and technologically advantaged barriers to entry. For example, firms that have invested heavily in developing straight-through processing (including taking orders directly from customers' systems) or those that have developed derivative trade evaluation tools and research services for customers (as long as execution is tied to these services) likely would benefit from defending these positions.

- **Improve collateral management and clearing capabilities,** as these are likely to have heightened importance in the new market. In addition to requirements mandated by the Dodd-Frank Act, Basel III includes significantly enhanced standards for collateral modeling, margining and operational processes.

- **Optimize trading book inventory,** as capital requirements for trading book assets are set to increase dramatically under Basel III (up to three to five times for lower-rated assets). These changes may result in reduced staffing requirements on trading desks as well as lower trading book inventory; however, firms should weigh the capital and cost benefits of such changes against the risk of slower client execution.

In addition to extensive changes for OTC derivatives, the Dodd-Frank Act also introduces a number of changes for securitization markets, including a requirement to retain at least 5 percent of securitizations (with some exceptions for qualified residential mortgages) and the inclusion of off-balance-sheet structures in capital calculations. These changes are likely to slow the recovery of securitization markets (Exhibit 4). Lending for non-qualified residential mortgages is likely to require significantly more capital as a result of the Dodd-Frank Act. Furthermore, qualified residential mortgage markets may change if Congress returns to the topic of Fannie Mae and Freddie Mac reforms during 2011.

Exhibit 4

Dodd-Frank is likely to make securitization significantly less appealing as a funding mechanism for banks

4 key provisions in Dodd-Frank relating to securitization:

1. **Risk retention** (ie, "skin in the game")
2. Enhanced **disclosure and reporting** standards
3. Increased **reps and warranties** and stronger enforcement mechanisms
4. Augmented **due diligence** requirements

Definition of "**qualifying residential mortgage**" to be issued by federal banking agencies, SEC[1], HUD[2], and FHFA[3]

Risk retention

- For nonqualifying residential mortgages: minimum **5% retention** of the credit risk
- For transactions consisting entirely of **qualifying residential mortgages**: no retention requirement
- For CDOs[4] and other resecuritizations: retention requirement to be later determined
- Securitizers are **prohibited from hedging** (directly or indirectly) or transferring the retained risk
- **Allocation of risk retention** between securitizer and originator to be determined later by regulatory agencies

[1] Securities and Exchange Commission; [2] US Department of Housing and Urban Development; [3] Federal Housing Finance Agency; [4] Collateralized debt obligation.

In response to the new retention and higher capital requirements, particularly for less-creditworthy segments, we anticipate a reduction in volume for complex securitizations, an increasing emphasis on "vanilla"/pass-through products and a decline in warehousing and off-balance-sheet funding structured investment vehicles (SIVs), conduits, and asset-backed commercial paper (ABCP) maturity transformations. In addition to these structural changes, investors are likely to benefit from better origination/underwriting standards and improved documentation of securitized loans.

For those segments that are most affected by the shift in securitization volume, such as non-qualified residential mortgages, alternatives are likely to include retention of loans on balance sheets, as well as whole loan sales and syndication of loan portfolios. Banks that have adequate regulatory capital and origination capabilities may realize somewhat higher net interest margins for non-qualified mortgages, while banks that are relatively constrained in terms of regulatory capital may be able to take advantage of their branch networks and relationships to generate fee income by selling or syndicating whole loans to institutions that face fewer capital constraints (perhaps with some risk retention). This relationship could prove advantageous for US banks, which could serve as originators of non-qualified residential mortgages and then sell or syndicate packages of whole loans to other investors or to banks with smaller branch networks but stronger capital cushions.

Proprietary trading

New restrictions on proprietary trading could shift position taking toward nonbank firms and international banks not subject to US financial regulations; however, trading banks may have up to seven years to respond

The Volcker Rule prohibits pure proprietary trading and limits investments in hedge funds and private equity firms to 3 percent of Tier 1 capital for US banks; however, the rule provides broad exceptions, such as allowing market making and other client service activities as well as hedging of the bank's own exposures.

Although banks have up to seven years to implement the final rules, several large US-headquartered banks already have made strategic changes to their proprietary trading operations and other businesses likely to be affected by the Volcker Rule. These changes include closing down certain proprietary trading departments, spinning off hedge funds, and moving proprietary traders to asset management divisions.

While uncertainty remains about what will ultimately be considered "proprietary trading," banks can undertake a number of tactical initiatives immediately:

- **Improve technology and risk-management systems** to enable identification of transactions that are client-related or hedges of the bank's own exposures. While it is relatively simple to identify trades for firms' pure proprietary trading desks (e.g., those few transactions conducted in a "glass room" proprietary trading environment wholly separate from customer-facing activities), segregating position-taking from market-making activities at the majority of trading desks can be far more challenging. Many trading desks are allowed to maintain inventories and take positions within risk limits, and many of those securities and transactions often can (and should) be viewed as facilitating customer business. For example, it is unclear whether regulators will consider a significant delay in hedging customer trades "proprietary trading." Firms can prepare by enhancing their systems' ability to flag or associate trades that are executed in anticipation of, or subsequent to, related customer business, or that are executed in a related but not identical underlying asset.

- **Further enhance customer service and client-facing activities** relative to position-based activities, by changing front-office business models to make money from capturing bid/ask spreads and working large positions rather than from retaining unhedged exposures. This would require increased focus on banks' sales forces, tightening position limits for front-office personnel, as well as on improving execution and risk management capabilities. Banks may also consider exploring more substantial shifts, such as changing corporate structures and relocating key trading personnel to entities that are less likely to be affected by the Volcker Rule.

- **Evaluate whether these rule changes present an opportunity.** For example, hedge funds, large investment managers, and other firms not subject to this regulation may be able to take advantage of the shift in market dynamics. These firms may be able to attract talent while the implementation details of the Volcker Rule remain uncertain, and may also attract capital from investors who are willing to tolerate higher-risk activities.

Debit and credit cards and checking

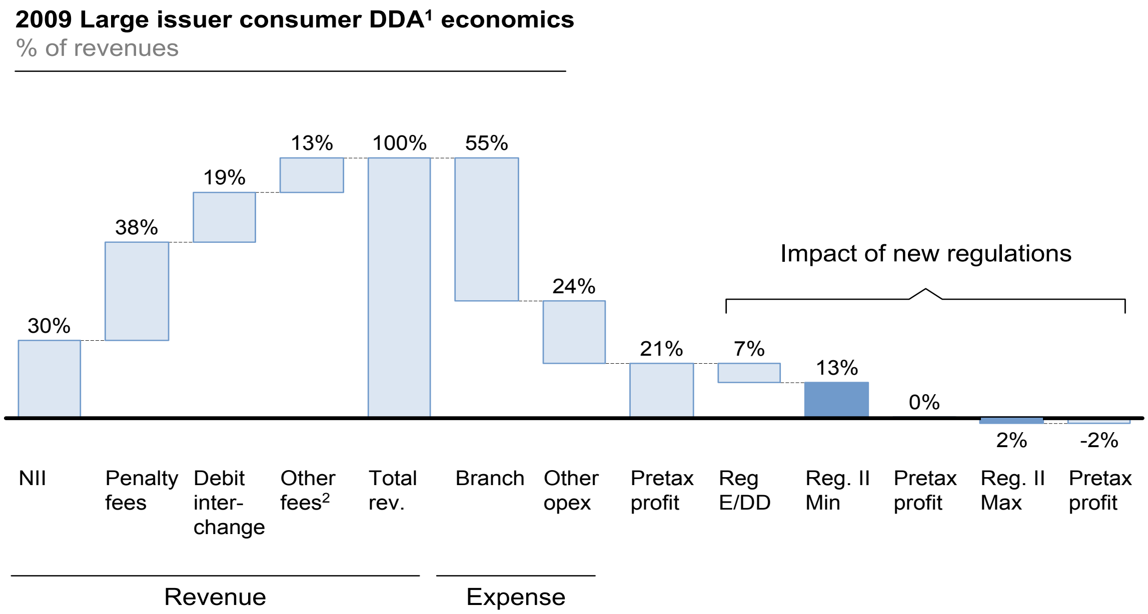
New interchange fee regulations could significantly reduce industrywide profits for consumer checking and credit cards, prompting card issuers and networks to make changes, such as the elimination of universal "free checking"

The Durbin provisions of the Dodd-Frank Act allow the Federal Reserve to limit debit interchange fees to a rate that is "reasonable and proportional" to issuer transaction costs, potentially constraining one of the few remaining growth engines for consumer banking. Exhibit 5 illustrates that the Durbin provisions would eliminate virtually all consumer checking profits when combined with accompanying overdraft regulations.

The new provisions are likely to have secondary implications for other business lines, including card networks, merchant processing, prepaid issuing, and issuer processing, and will affect credit card issuers as low debit interchange fees may create incentives for merchants to steer transactions away from credit and toward debit cards, eliminating an estimated 70 to 85 percent of debit interchange for large issuers.

Exhibit 5

New regulations cut deeply into consumer DDA margins



1 Demand deposit account.
2 Includes maintenance fees and fees for ATM use, check cashing, check reorder, stop pay, wire transfer, and other usage fees.

Source: McKinsey US Payments Map, 2009–2014, Release Q1-2011

In addition to lowering overall industry pre-tax profits, the Dodd-Frank Act is likely to cause banks to reinvent their approach to pricing for credit cards and demand deposit accounts (DDAs) and to reevaluate their network strategy and the economics of many customer relationships. We recommend that banks consider five tactical priorities:

- **Refine the economic model, including pricing,** by designing products and services that can support fees for those customers where product economics are not viable otherwise. We estimate that banks will impose fees on 10 to 35 percent of checking accounts, particularly lower-balance accounts (e.g., by reducing universal “free checking” or introducing usage charges), so banks may benefit by finding ways to package and price checking features according to consumer value—potentially shifting to products with more fees but fewer penalties.

- **View the DDA as part of a broader customer relationship.** Given the “stickiness” of DDAs with direct deposit, an account that might not be profitable on its own could be the lynchpin of a profitable relationship with the customer—provided that the bank can serve the customer with a tailored suite of banking products. Customers are likely to consolidate banking relationships in response to increasing fees per account (e.g., by closing less actively used credit cards that have newly imposed fees), which creates additional incentives to deepen the customer relationship.

- **Explore additional solutions to containing costs,** including the reduction or elimination of services and rewards, improved product design, such as online-based products or a drive to electronic servicing.

- **Shift network strategy** by signing new partners and working closely with networks and acquirers to develop better interchange pricing policies. Significant price reductions are likely to be required in certain categories to slow or prevent merchant discounting.

- **Continue to negotiate with regulators** to ensure that new fee restrictions incorporate all of the costs associated with providing interchange services, including investments in technology, security, fraud prevention, and privacy, in addition, to earning some margin on invested capital.

Exhibit 6

Basel III and Dodd-Frank will also affect other businesses

	Line of business	Business implications
Financing to financials	Direct lending to financial firms	▪ Reduction in bank lending to financial institutions, with shift toward public market issuance and nonbank lending ▪ Increase in secured lending among financial institutions ▪ Likely increase in interbank borrowing costs, potentially with higher LIBOR[1] ▪ Moderate rate increases for end customers, both for secured and unsecured lending ▪ Likely increase in cost for credit facilities provided by banks
	Prime brokerage	▪ Higher administrative costs, lower volume and lower availability of securities for short selling ▪ Increased pressure for secured funding and ability to self-fund trading businesses ▪ Increased operational complexity arising from additional collateral movements and interaction with CCPs[2] custodians, and collateral agents ▪ Operational complexity related to segregation of excess collateral for derivatives, unencumbered customer assets, and cash
Financing/ corporate lending	Liquidity lines of credit	▪ Increase in cost of liquidity and net reduction in liquidity credit lines and commercial-paper issuance ▪ Shift toward direct lending ▪ Reduction in muni VRDNs[3] using banks for a liquidity backstop ▪ Potential addition of MAC[4] clause to enable banks for some facilities to cancel lines of credit if funding would impair their own liquidity position
	Direct lending to nonfinancial corporates	▪ Higher margins for cyclical businesses ▪ Reduction in lending for recovering borrowers (eg, last cycle's losers continue to be "penalized" because of the cyclicality of loss models)
Consumer/ retail banking	Consumer and small-business lending	▪ Higher rates and reduced access to credit, particularly for segments with higher EL due to either low creditworthiness or lack of collateral (eg, significant reduction in subprime) ▪ Better origination/underwriting standards and documentation, including emphasis on income verification (potentially via third-party providers) ▪ Increase in staged issuance, as funds are dispersed gradually against real collateral ▪ Reduction in new products and increased time to market as banks anticipate consumer financial protection rules ▪ Reduction in lending for recovering borrowers (eg, last cycle's losers continue to be "penalized" because of the cyclicality of loss models) ▪ Access to credit for disadvantaged segments is likely to shift outside of the regulated financial industry ▪ Longer-term products to be funded increasingly with longer-term liabilities

[1]London Interbank Offered Rate. [2]Central counterparty. [3]Variable rate demand note. [4]Marginal abatement cost.

Other business lines such as mortgage lending

We believe that financial institutions would gain from conducting a thorough review of each business, incorporating the prospective impacts of the legislation on profitability

Even for businesses that are not targeted directly by the provisions within the Dodd-Frank Act, future profitability is likely to be affected indirectly in a variety of ways. For example, each line of business will face new strategic challenges and most will be affected by "heightened" and "more stringent" prudential standards and higher fixed costs of compliance with new regulatory and consumer protection requirements. For example, we anticipate a variety of changes for mortgage lending, such as:

- **Capital and funding:** Although qualified residential loans are exempted from the changes in requirements for securitizations, funding costs and capital levels are likely to increase for non-qualifying mortgages, particularly for non-prime and both funded and unfunded home equity lines. As a result, subprime and jumbo loan rates are likely to increase significantly if banks are able to pass these higher costs along to buyers, all else equal. Funding costs may increase further as the Basel III net stable funding ratio (NSFR) is implemented in 2019 and beyond.

- **Mortgage servicing rights (MSRs):** Under Basel III, MSRs in excess of 10 percent of Tier 1 common will be deducted from Tier 1 capital directly and includable MSRs will be subject to a 250 percent risk weighting. For large originators, this will make securitization a much less attractive funding option and may lead to the separation of servicing and MSR ownership, with an increase in third-party subservicing and excess MSRs being purchased by financial investors.

- **Balance sheet:** New requirements to retain at least 5 percent of non-qualifying mortgage securitizations and to include off-balance-sheet entities in capital calculations are likely to expand bank balance sheets and Basel III requirements are likely to increase the portion of mortgage assets that must be funded with more expensive long-term debt. These changes are likely to lead to higher costs and higher capital requirements.

- **Product development:** The new Consumer Financial Protection Bureau will have authority to review loan products and label them as "abusive." Banks will need to develop products that follow the letter and spirit of new consumer financial protections to guard against legal liability and to protect their reputations.

- **Operational costs:** Banks will need to incorporate new and ongoing costs into loan pricing, such as regulatory compliance overhead, training, consumer protections and new reporting requirements (e.g., ensuring that every customer is able to afford his or her mortgage loan payments).

- **Business volume:** Mortgage origination and refinancing volumes may decline in response to expected tightened underwriting standards, higher underwriting and product development expenses, and increased capital and funding costs. If this occurs, then mortgage pricing, cost structures, and business models will need to adjust accordingly.

- **Other businesses:** Exhibit 6 summarizes some of the other business line changes that are likely to result from the Dodd-Frank Act and Basel III changes.

We believe that financial institutions would benefit from conducting fully loaded profitability analyses to estimate the future returns of each business. Such analyses would incorporate the direct and indirect impacts of the legislation, as well as likely competitive responses and could identify which businesses would produce the most attractive returns on capital. Exhibit 7 outlines a process that could be applied across business lines to classify businesses into three distinct groups:

Exhibit 7

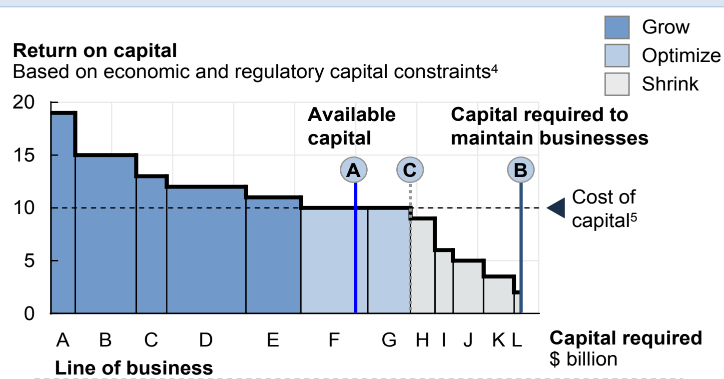
CONCEPTUAL EXAMPLE

Banks may need to reassess the profitabilityof each line of business

Process for estimating the capital impact of Dodd-Frank on each line of business

1. **Evaluate revenue and cost impact** of each business, incorporating anticipated business responses
2. **Calculate pro forma capital requirements** for each line of business using both regulatory capital (RORC[1]) and economic capital (RAROC[2])
3. **Conduct a fully-loaded profitability analysis** to estimate pro forma through-the-cycle returns, including transfer pricing and interactions among businesses (eg, DDA[3] cross-selling opportunities)
4. **Rank businesses by return on capital and capital requirements** to identify potential capital constraints
5. **Determine best response** for each business. For example,
   – Re-allocate capital to more profitable businesses
   – Optimize capital usage for businesses with marginal returns on capital
   – Shrink unprofitable businesses to reduce capital requirements
6. **Redesign business or funding models** for businesses made unprofitable

Approach for allocating available capital to businesses with the highest pro forma returns on capital



(A) Available capital (eg, current regulatory capital) is allocated to businesses that are most profitable on a risk-adjusted basis. If excess capital exists, more profitable businesses could expand without requiring additional capital issuance

(B) Capital required to maintain businesses represents the amount of capital required by existing businesses after incorporating additional regulatory capital requirements

(C) Optimal capital level: consider scaling down or managing risks more effectively for businesses that do not meet the hurdle rate

1 Return on risk capital. 2 Risk-adjusted return on capital. 3 Demand deposit account. 4 Businesses should evaluate returns based on both economic capital (RAROC) and regulatory capital (RORC) constraints. 5 Cost of capital represents the risk-adjusted cost of capital for each line of business.

- Prospective returns above the cost of capital
- Prospective returns near the cost of capital
- Prospective returns significantly below the cost of capital

Financial institutions should reallocate capital to support businesses with prospective returns above the cost of capital and should search for ways to optimize the capital efficiency of businesses with marginal expected returns on a go-forward basis. Contingent on capital availability, financial institutions should continue this process for each line of business that can produce returns above its risk-adjusted cost of capital. Those businesses whose return on capital remains marginal even after optimization should be crowded out or substituted by alternative products and business structures. However, the right answer for each financial institution will be highly dependent on context and higher-cost businesses with a healthy market share may still have a place in the portfolio if their pricing power is strong.

2) Optimize capital and liquidity management

The Dodd-Frank Act empowers regulators to enact “more stringent” prudential standards, but it does not yet define many specific requirements for firms under the oversight of the Council and the Federal Reserve Board; however, using the Basel III requirements as a proxy, we can estimate a “lower bound” of potential impact on affected firms.

Prudential standards for capital

Basel III lays out stricter definitions of eligible bank capital (including the exclusion of deferred tax assets that rely on future profitability, hybrid capital instruments and minority interests from capital), increased risk weighting on assets, a prescriptive leverage ratio (that does not allow the netting of derivatives, repos and securities lending), and specific liquidity rules.

If estimated Basel III affects are an indicator, the Dodd-Frank Act prudential standards will require significantly higher regulatory capital and liquidity levels. Based on Basel III requirements, we estimate that the US banking sector would need to raise or retain approximately $500 billion of Tier 1 common equity—about 17 times the average issuance in the last decade (Exhibit 8).[3]

We estimate that normalized returns on equity (ROEs) for affected US banks may decline by ~320 basis points as a result of the proposed Basel III capital and liquidity changes, absent any countervailing changes in banking business models (Exhibit 9). This represents a decline of over 25 percent from the average industry ROEs achieved during the period from 1960 to 2006. Overall ROE declines may be even higher, since many of the revenue-related provisions of the Dodd-Frank legislation have yet to be defined.

As a result of these additional equity and funding needs, regulatory capital is likely to become a constraint at many firms, significantly affecting the industry:

- Banks that are less constrained by regulatory capital may have a near-term competitive advantage, particularly in businesses that have relatively lower returns on regulatory capital. Competitors that have higher capital constraints are likely to reduce their footprints in businesses with higher regulatory capital needs versus returns. Banks that are less constrained by changes in regulatory capital needs would be well positioned to maintain or grow their footprints in such businesses as long as the returns on economic and regulatory capital exceed return hurdle rates

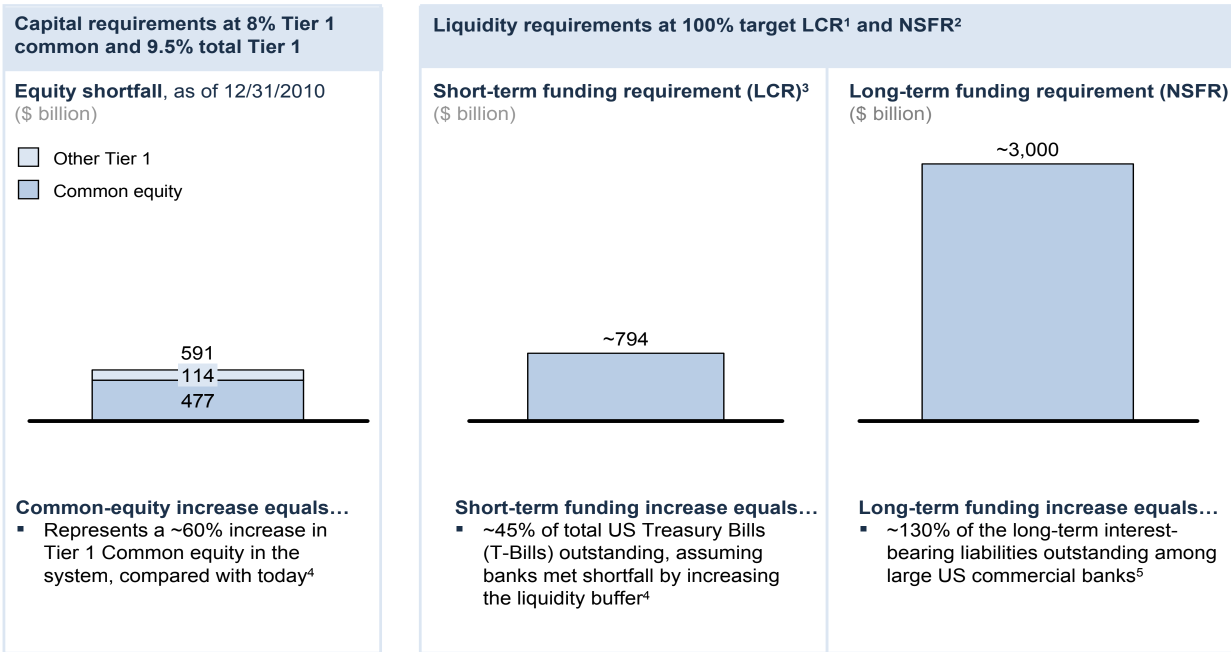
- Banks that have a strong capital management approach in place to optimize returns on regulatory capital (RORC) and risk-adjusted returns on economic capital (RAROC) will be better positioned to optimize the strategic decisions that rely on business unit return assessments. As a result of the heightened capital constraints, banks likely will need to make such strategic business choices—and doing so with the benefit of RORC and RAROC measures will help to improve them

3 This is assuming that US banks hold an additional 100 basis points of Tier 1 common capital above the 7 percent minimum requirement.

OUTSIDE-IN ESTIMATE

Exhibit 8

Dodd-Frank may exacerbate impact on capital and funding due to Basel III



1 Liquidity coverage ratio.
2 Net stable funding ratio.
3 Short-term funding requirement (LCR) assumed to be 5% of total assets.
4 T-Bills outstanding of $1,768bn as of 10/31/2010.
5 Interest-bearing liabilities include $2,060bn in interest-bearing deposits and $277bn in long term corporate debt among BHCs > $10bn in assets, 9/30/2010.
Note: Estimates incorporate impacts of the Basel III July 26th annex and September 12th announcement.
Source: BIS; SNL; RMA analysis; Barclays Capital analysis; McKinsey analysis

In response to the changing capital requirements, we recommend that banks adopt or enhance three initiatives relating to their capital management framework:

- **Create full transparency on capital management** by enhancing frameworks and processes used to manage economic and regulatory capital, including the reallocation of capital to the most advantageous lines of business and the incorporation of capital allocation into business processes (e.g., RAROC-based performance measurement)

- **Minimize capital waste and leakage across all businesses.** Ensure that processes are tightly managed for capital (e.g., ensure counterparties are rated, collateral is managed tightly, and risk models are used to appropriately allocate economic and regulatory capital to businesses with optimal capital and risk-adjusted returns)

- **Redefine business models for efficient capital usage.** Review business activities in the context of capital optimization (e.g., review client portfolio for capital waste, align sales representatives' incentives with capital consumption, and compensate business leaders on return on capital). Firms may also want to ensure that processes, tools, and data are sufficient to make such evaluations and business decision making.

Prudential standards for liquidity

Absent structural changes, meeting potential liquidity prudential standards (again, using estimated Basel III as a guide) would require US banks to hold approximately $800 billion of additional liquid assets—equal to approximately 45 percent of US Treasury bills currently outstanding. Additional liquidity standards are likely to significantly affect profitability of firms and individual businesses on a fully allocated basis.

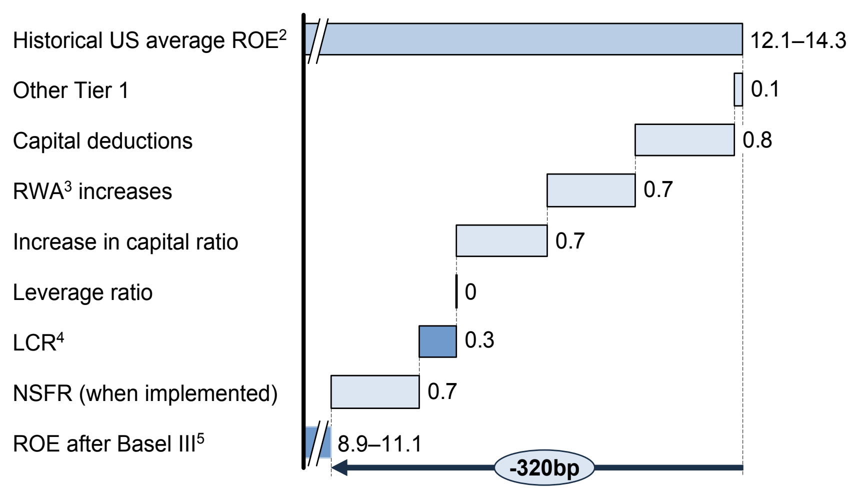
Given heightened liquidity requirements, institutions should reassess the liquidity implications for lines of business and even for individual transactions (e.g., benefits of retail versus wholesale funding and funding costs of longer maturity commitments).

Exhibit 9

Basel III would lower US banking ROE by ~320 basis points, assuming no changes to business models

PRELIMINARY ESTIMATES

ROE[1] impact of Basel III capital and liquidity proposals
Percentage points



Changes not included in modeling

- Future "too big to fail" taxes
- Volcker Rule
- Central clearing of OTC[6] derivatives
- Rapid resolution plans
- Bank taxes/levies
- Accounting
- Consumer protection
- …

- Key **question is where the costs** of regulatory changes **will fall**; ie,
  - **On customers**, through higher loan pricing and reduced availability of credit
  - **On banks**, through cost reduction (eg, compensation, consolidation among small banks)
  - **On shareholders**
- Even in an environment where banks are better capitalized and liquid, the declines in ROE are unlikely to be matched by a corresponding reduction in the cost of equity due to lower industry volatility (as Modigliani-Miller would suggest)

1 Return on equity.
2 Based on consensus 2012 analyst forecasts (12.8) and average industry ROE between 1960 and 2006 (14.3).
3 Risk-weighted asset
4 Assumes full liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) implementation.
5 Estimates incorporate impact of the Basel III July 26th annex and September 12th announcement.
6 Over the counter.
Source: McKinsey analysis

The value of understanding, planning, and managing liquidity will increase dramatically with these new requirements. Collecting and measuring such information may require investments in data and modeling capabilities as well as in the personnel to make such decisions.

In response to the changing liquidity requirements, financial institutions should consider several opportunities:

- **Reduce trapped liquidity pools and reallocate liquidity.** As in capital optimization, ensure that liquidity is centrally managed across geographies and legal entities and that scarce liquidity is allocated to its most advantageous uses. In addition, the impact of creating international pools of cash with limited global/inter-company mobility should be weighed carefully against the tax and other benefits.

- **Enhance liquidity allocation and modeling.** Refine funds transfer pricing mechanisms to more fully include the cost of liquidity requirements and improve the understanding of complex liquidity needs (e.g., liquidity implications of stresses in derivatives books), to ensure that product economics reflect the true cost of liquidity.

- **Redesign product offerings based on liquidity requirements.** The Basel III liquidity coverage ratio requires banks to hold highly liquid securities against unfunded lines. Banks can reduce the impact of this change by shifting toward a direct lending model while reducing liquidity credit lines and commercial paper issuance. Liquidity requirements also may be reduced through the addition of provisions that enable banks to cancel facilities if funding would impair their own liquidity position.

3) Broadly upgrade risk and regulatory compliance capabilities

The Dodd-Frank Act provides broad authority for regulators to raise risk management standards, including rapid resolution plans to facilitate the liquidation of distressed firms, semi-annual stress tests to assess capital adequacy under severely adverse conditions, and detailed reporting on any activity that the Office of Financial Research (OFR) believes may "pose a threat to the financial stability of the United States." Instead of responding to these new requests in an ad hoc or piecemeal manner, banks should seize this opportunity to upgrade their practices and improve overall risk management, for example, by improving their ability to aggregate consolidated risk exposures, tracking counterparty exposures across legal entities, or tracking clearing and settlement activities in real time. Though challenging, these enhancements would improve risk management and help meet the new requirements.

In addition to the specific requests of the legislation, banks should continue to upgrade their risk and compliance capabilities in several areas:

- **Strengthen dynamic risk reporting capabilities** to provide a timely enterprise view of risk that also provides appropriate detail within specific lines of business. The Act authorizes the new OFR to establish and standardize financial information, including the collection of "financial transaction data and position data from financial companies." Given that the OFR is responsible for monitoring systemic risks, these new reporting requirements could require banks to produce detailed, consolidated views of risk along multiple dimensions. Even absent any regulatory push, investing in the capability to quickly and accurately access risk data can pay off in the form of improved risk transparency.

- **Automate manual risk management and regulatory compliance processes, where possible.** Automation of processes that may not have been economic prior to the legislation may represent opportunities in the new environment. For example, banks may be able to reduce ongoing regulatory costs by more fully centralizing and standardizing manual activities. By integrating data from different sources, a financial institution may develop a more comprehensive view of risk and enable a more effective response; however we recommend assessing the benefits of such investments deliberately, including both vendor and in-house solutions, in order to maximize the return on technology investments.

- **Institutionalize stress-testing and leverage it for setting risk appetite** using a robust and comprehensive approach that can be applied across multiple scenarios, in addition to the required "base," "adverse," and "severely adverse" scenarios. The additional stresses should be based on both historical and hypothetical scenarios, and the tests should incorporate credit and market losses, as well as the impact on the bank's earnings, balance sheet, and liquidity. The stress tests should be capable of highlighting areas where concentrations or exposures are higher than management tolerances, where cross-business correlations could bring unintended consequences and should help the bank ensure that its risk profile is in accordance with its stated risk tolerance.

- **Simplify legal entity structures, where feasible.** The new regulations significantly reduce the capital relief provided by off-balance-sheet entities, and rapid resolution plans emphasize the need for a consolidated view of exposures. In simplifying complex legal structures, banks should balance tax and funding considerations against the costs of increased regulatory requirements.

4) Manage costs even more aggressively

Regulatory reforms are likely to result in broadly increasing costs for large banks arising from multiple new regulatory requirements:

- **Higher funding rates and costs of capital:** Increased requirements for more expensive and higher quality capital and potential longer-term funding requirements will drive up funding and capital costs.

- **New fees and assessments:** New expenses built into the legislation, including a potential doubling of FDIC deposit insurance fees and new bank holding company examination fees.

- **Cost of expanded regulatory interactions:** The day-to-day cost of regulatory compliance is likely to increase in response to the increasing requests of new and existing regulators, as well as new reporting requirements from new agencies such as the Consumer Financial Protection Bureau and the Office of Financial Research.

- **Specific costs of new requirements:** In addition to the direct regulatory costs listed above, there also will be new expenses embedded into ongoing business processes, such as the cost of new training, documentation and consumer financial protections (e.g., formal verification of borrower payment capacity for mortgage loans).

- **Increased legal expenses:** Legal expenses associated with consumer-facing products may increase as the Bureau's approach to regulation evolves.

For the largest bank holding companies, we estimate that these changes may result in direct implementation costs in excess of $100 million and acute ongoing cost pressures that will increase the need for affected firms to intensify their efforts to manage expenses. In addition to managing costs in each business line, banks may need to reevaluate corporate center and support functions to ensure that the overall cost structure is appropriate for the new environment.

5) Ensure that the internal culture and processes reflect "customer first" themes

The newly formed Consumer Financial Protection Bureau will centralize responsibility for enforcing compliance with federal consumer protection laws to protect consumers from unfair, misleading, or abusive products and practices. The Bureau will have broad authority to conduct examinations and issue orders over a wide range of entities offering consumer financial products or services to consumers.

In addition, the Securities and Exchange Commission (SEC) is studying a number of investor protection proposals, including the introduction of fiduciary standards for brokers and investment advisors, a new Investment Advisory Committee, and a whistleblower reward fund. These proposed investor protections may be expanded further during the next several years as regulators continue to enhance customer (particularly retail customer) rights.

In anticipation of these changes, we believe that financial institutions would gain from enhancing the review process for products and services to ensure compliance with Bureau and SEC standards. In addition, financial institutions may benefit by proactively communicating these practices internally and publicly. Financial institutions may find that building a culture that meets the spirit of the "customer first" themes of the legislation can help mitigate some of the associated risks with the new legislation (in particular among frontline employees). Banks could strengthen this culture by focusing on four dimensions:

- **Training and communication:** Enhance the incorporation of concepts such as suitability and fiduciary standards into training for new employees and communicate these standards clearly to existing employees. Topics may include how frontline employees work with customers during product selection, fee-setting, and pricing and serving as investment advisors.

- **Tools for compliance:** Develop measures and metrics to monitor performance of both individuals and lines of business against the consumer protections required by the Bureau as well as the "customer first" aspirations of the organization and monitor these metrics rigorously.

- **Incentives:** Assess whether the incentive system incorporates "customer first" themes, for example, by including specific compliance and customer service metrics into employee performance reviews. Significant violations should be addressed meaningfully every time.

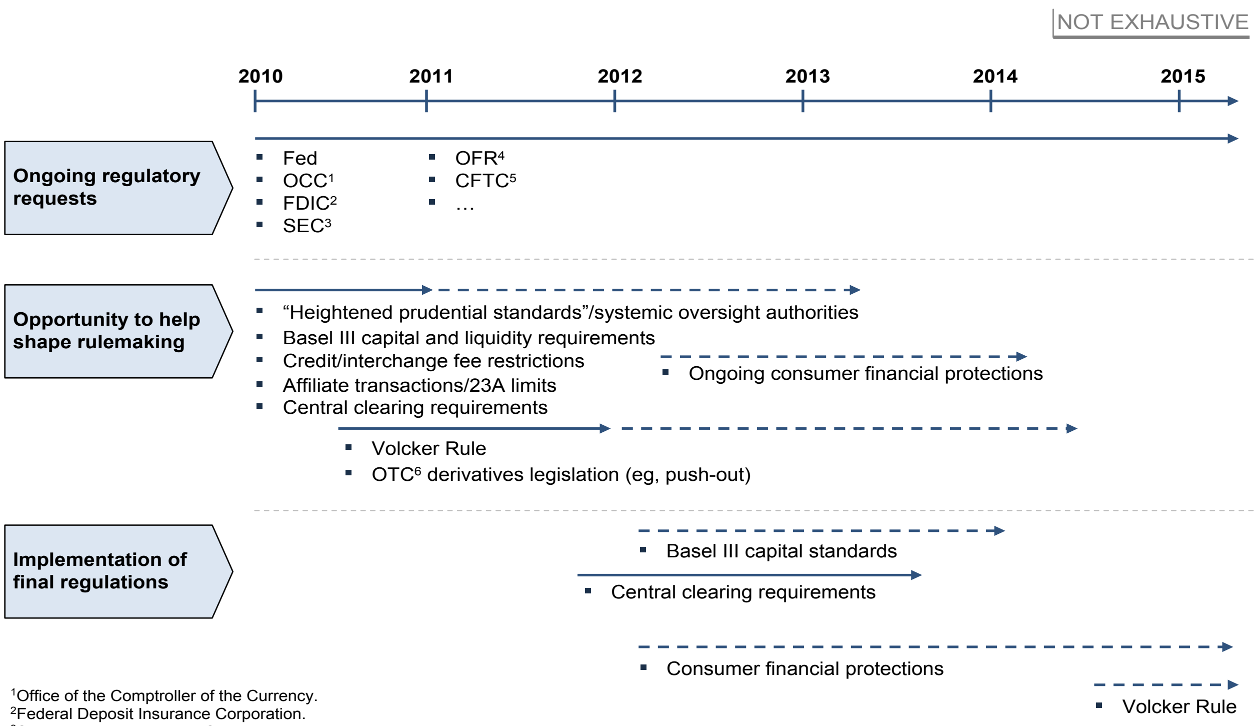
- **Role modeling:** We believe that management should act as a role model by clearly establishing the importance of consumer protections, both as a compliance issue and as a matter of business practice. Over time, these practices may instill customer loyalty and strengthen the bank's public image—an important outcome in an environment in which banks will be increasingly dependent on customer relationships.

6) Accelerate the implementation of the new regulatory requirements

Many critical details of the new regulations have yet to be specified by the Federal Reserve, the SEC, the Consumer Financial Protection Bureau, the Office of Financial Research, and other regulators. As noted earlier, the bill mandates at least 200 new rules and regulations and 67 studies be conducted over the next 6 to 18 months (Exhibit 10). The final requirements that banks and designated nonbanks will need to implement will depend largely on the results of those forthcoming rules and studies.

Exhibit 10

Banks have an opportunity to shape the implementation of Dodd-Frank



[1]Office of the Comptroller of the Currency.
[2]Federal Deposit Insurance Corporation.
[3]Securities and Exchange Commission.
[4]Office of Financial Research.
[5]Commodity Futures Trading Commission.

Source: BCBS; US House and Senate; McKinsey analysis

In order to adapt to the rapidly evolving regulatory environment, we believe that banks will benefit by developing (or enhancing) a formal project management team to ensure ongoing compliance with new requirements and the increasing volume of regulatory requests. This response team would require significant senior management involvement and extensive collaboration across functions. One possible team configuration would be led by a centralized "regulatory response" team that serves to coordinate across a number of regulatory initiatives. The regulatory response team might consist of a full-time senior manager supported by:

- **One centralized coordination team,** managing projects on a consolidated basis
- **Multiple project teams** to drive initiatives in specific areas, each reporting within the regulatory response team and leveraging functional leads and business area liaisons (e.g., liquidity management re-design, Basel Pillar 2/ICAAP, transition to derivatives clearing requirements)
- **Functional leads from each support area** to serve as primary points of contact with the project leads (e.g., technology, risk, operations)
- **Embedded business area liaisons** reporting within each business area, but working closely with the project teams on specific initiatives

- **Senior regulatory liaisons** who interact frequently with regulators to understand supervisory expectations and to communicate the bank's perspective on key regulatory topics

In addition to serving as a common point of interaction for businesses and as the primary point of contact for managing competing regulatory demands, the team would be responsible for anticipating and monitoring changes in requirements, drawing implications, developing plans for coordinated enterprise-wide responses, and implementing changes as the requirements are finalized. Exhibit 11 outlines the key responsibilities of the regulatory response team.

Exhibit 11

The regulatory response team should manage the day-to-day challenges of the transformation

	Regulatory response team responsibilities
Monitor regulatory requirements and assess regulatory proposals	▪ Develop compliance plan to track all regulatory deadlines ▪ Assign point of contact for every rule ▪ Analyze regulatory proposals and identify affected businesses
Coordinate implementation across business areas and geographies	▪ Orchestrate workplan implementation across stakeholder groups ▪ Evaluate required technology solutions ▪ Mediate resource conflicts, with resolution authority
Track progress against workplans and report to senior management	▪ Manage progress against specific deadlines ▪ Identify bottlenecks and resolve issues ▪ Report progress to senior management against comprehensive set of regulatory changes
Develop comprehensive solutions to ensure cost-effective compliance	▪ Create implementation plan and timeline ▪ Collaborate with businesses to outline cost-effective implementation path ▪ Share best practices and champion alternatives
Assess impact of regulatory changes at business line and consolidated level	▪ Develop tools to estimate impact (eg, decision tools, KPIs[1], cost calculators) ▪ Spearhead impact assessments with BU teams (eg, profitability analyses, review of target customer segments) ▪ Communicate perspectives to key stakeholders, including regulators

[1]Key performance indicator.

Appendix: a summary of key provisions of the Dodd-Frank Wall Street reform and consumer protection act

The Dodd-Frank Act includes five critical areas that will affect financial institutions' earnings, viability, and competitiveness:

1) Expanded regulatory oversight of financial firms

2) New operating restrictions on financial activities

3) Increased mandates for firm governance

4) "More stringent" prudential regulatory standards

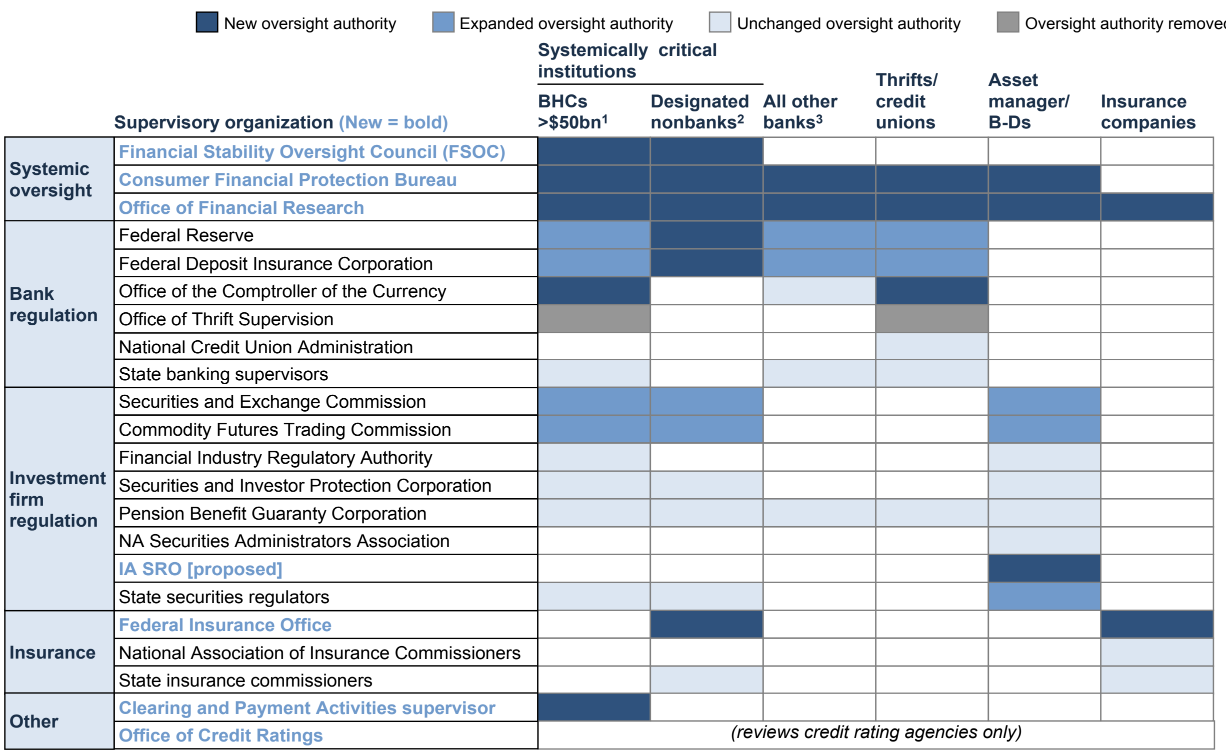
5) Significantly higher regulatory costs for larger firms

1) Expanded regulatory oversight of financial firms

There are several significant changes in the new US regulatory architecture. Exhibit 12 summarizes these changes, which are described in more detail below.

Exhibit 12

Dodd-Frank expands regulatory oversight across an already complex and fragmented regulatory landscape



1 Includes holding company and subsidiary entities
2 Nonbank financial institutions designated by the FSOC for Federal Reserve oversight (eg, systemically important nonbanking financial institutions)
3 BHCs (bank holding companies) with consolidated assets below $50bn that are not designated for FSOC oversight

- **New Financial Stability Oversight Council (FSOC):** This Council of all federal financial regulators is meant to improve coordination and cooperation to achieve financial stability and mitigate systemic risk. Chaired by the Secretary of the Treasury, the Council consists of ten voting members: the Federal Reserve, Comptroller of the Currency, FDIC, SEC, Commodity Futures Trading Commission (CFTC), National Credit Union Administration (NCUA), Federal Housing Finance Administration (FHFA), the new Consumer Financial Protection Bureau, and an independent member. Non-voting members include the new Federal Insurance Office (FIO) and Office of Financial Research (OFR) at the Treasury Department, and representative state banking, insurance and securities regulators. The Council has new macro-prudential supervision and market surveillance responsibilities, but it is not a regulatory agency and can only make recommendations to other regulators. The Council also has new oversight responsibilities for accounting.

  The United States becomes one of the few G20 countries, along with China and Argentina, to have financial regulation under the direct influence of a nation's finance ministry. The United Kingdom, by contrast, has just moved its single prudential regulator, the Financial Supervisory Authority, into its central bank, the Bank of England, and created separate consumer and enforcement agencies.

- **Enhanced Comptroller of the Currency (OCC):** The Office of Thrift Supervision (OTS) is merged into the OCC, so all savings and loans and S&L holding companies with less than $50 billion in assets will now be supervised by the OCC. The thrift charter remains intact, but it is now subject to OCC regulation and supervision under a new Deputy Comptroller for Thrifts.

- **Consumer Financial Protection Bureau ("the Bureau"):** The new independent bureau within the Federal Reserve will oversee all banking and lending products, services and activities of all banks and nonbank providers. The Bureau has sweeping authority over potential pricing issues and for determining what practices may be "abusive," even after the fact. The Bureau has full enforcement authority over all institutions with greater than $10 billion in assets. Consumer enforcement for smaller firms will be left with their primary federal regulator (Federal Reserve, OCC, FDIC, FTC) and the Bureau will have no authority over insurance and securities products. Authority over auto dealers will be left to the FTC.

- **Federal Reserve:** The Federal Reserve takes on a significant new role as the Oversight Council's primary agent for "more stringent" prudential standards, with new regulatory and supervisory authority over all bank holding companies with assets greater than $50 billion and designated nonbank financial institutions. A new vice chairman for supervision will oversee its new supervisory responsibilities. For example, the Federal Reserve would have full regulatory and supervisory powers over AIG in the future and potentially new authority over Fannie Mae and Freddie Mac if designated by the Council.

- **Federal Deposit Insurance Corporation (FDIC):** The FDIC becomes the agent for the liquidation of large nonbank financial institutions (e.g., insurance companies, other large financial companies that are designated by the Council), in addition to retaining its traditional authority over the resolution of insured commercial banks and thrifts. The FDIC will also become the collection agent for any net Troubled Asset Relief Program (TARP) losses and additional assessments to fund the budget shortfall embedded in the Dodd-Frank Act programs and provisions. The Director of the new Consumer Protection Bureau replaces the OTS seat on the FDIC Board

- **Office of Financial Research (OFR):** The bill creates a new, industry-funded Office of Financial Research within the Treasury Department that will be responsible for developing an early warning system to monitor financial stability and systemic risks. The OFR will promote "best practices in risk management" and will have subpoena authority to require large banks to report standardized risk information. Additionally, the OFR will develop metrics and reporting systems to monitor systemic risk and will issue public reports on aggregate financial transactions and positions.

- **Securities and Exchange Commission (SEC):** The SEC gains new regulatory and supervisory authority over credit rating agencies, private investment funds (hedge funds and private equity fund registration and reporting), and investment advisors. The SEC will not be self-funded, but can submit its budget directly to Congress without prior White House approval, with authority to build up a $100 million reserve.

- **Federal Insurance Office (FIO):** The FIO is established within the Treasury Department primarily to monitor the insurance industry for systemic risk purposes. The FIO will interact with foreign regulators and agree to international insurance agreements on behalf of the United States; however, there is no provision in the Dodd-Frank Act for a national insurance charter and it will have no other independent regulatory authority over domestic insurance companies, which will be reserved to state regulators.

- **Federal preemption changes favoring states:** The final Act restricts the OCC's current authority and elevates the ability of the 50 states to have different consumer rules by stating that state law must "prevent or significantly interfere" with a "national bank's exercise of its powers" to be subject to preemption (in line with the Supreme Court's verdict in the Barnett Bank case). In addition, the final Act expands the authority of state attorneys general.

- **Source of strength doctrine:** The Federal Reserve's longstanding policy that bank holding companies (BHCs) must serve as a "source of strength" for their insured banks and thrifts is codified in law, which limits the ability of BHCs to rely on support from banking subsidiaries during stress periods.

2) New operating restrictions on financial activities

- **Volcker Rule restrictions on proprietary trading, hedge funds, private equity**

  Banks are banned from pure proprietary trading and from sponsoring and investing in hedge funds and private equity funds, with some exceptions. Total ownership of hedge funds or private equity funds may not exceed of 3 percent of the Tier 1 capital of the bank. The Oversight Council is required to study the impact of this rule within six months and the requirement will become effective no later than two years from the date of enactment, but banks and nonbanks will have two years to bring their portfolio into compliance with up to three one-year extensions, with a longer time frame for illiquid funds. Banks may have six or more years to fully implement these changes, although regulators can require additional capital during the transition period.

  Activity in US obligations, Ginnie Mae, Freddie Mac, Fannie Mae, Federal Home Loan Banks, and Farm Credit System, is permitted under the Volcker Rule:

  a. Underwriting and market-making activities to meet the "reasonable expected near-term demands of clients, customers, or counterparties"

  b. Risk-mitigating hedging activities of banks and nonbanks subject to Federal Reserve jurisdiction

  c. Purchase, sale and disposition of securities on behalf of customers

  d. Investments in Small Business Investment Companies

  e. Activities by a regulated insurance company, subject to numerous conditions

  f. Organizing and offering a private equity or hedge fund if the bank or nonbank provides bona fide trust, fiduciary or investment advisory services, subject to a number of conditions

  g. Proprietary trading by foreign banks and nonbanks operating outside the United States.

  h. Organizing and offering a private equity or hedge fund if the bank or nonbank provides bona fide trust, fiduciary, or investment advisory services by a foreign bank or nonbank, subject to a number of conditions

  i. Other activities that the regulators permit by rule in the future.

  However, these permitted activities restrict any action that would result in the following:

  - Material conflicts of interest
  - Unsafe or unsound exposure to high-risk assets or high-risk trading strategies
  - A threat to the safety or soundness of the bank or nonbank
  - A threat to US financial stability

Other activities, such hedge fund and private equity, are also permitted with certain restrictions. Banking entities that continue to engage in hedge fund and private equity (PE) fund activities are subject to Sections 23A and 23B under the Federal Reserve Act (affiliate transaction restrictions) as if they were member banks. Banks may not bail out hedge funds or PE firms in which they invest, subject to a five-year period to unwind.

Banks and nonbanks may continue to engage in prime brokerage transactions with any hedge fund or private equity fund, subject to a number of conditions. For example, CEOs must certify annually that they are not guaranteeing funds to which they serve as prime brokers.

Finally, nonbanks subject to the Federal Reserve jurisdiction will be subject to new conflict-of-interest rules relating to asset-backed securitizations:

- **Clearing requirements** for OTC derivatives: Over-the-counter derivatives will be subject to central clearing requirements and likely higher capital requirements. Regulators and clearinghouses will determine which contracts should be cleared and the SEC and the CFTC will be required to pre-approve contracts before clearinghouses may clear them.

- **Derivatives "push out":** The law sets rules for derivatives trading that allow banks to engage in derivatives transactions related to interest rates, foreign exchange, credit derivatives for investment-grade entities, gold, silver, and any hedging for their own risks. Only separately capitalized nonbank affiliates in a BHC can engage in other derivative activities related to energy, minerals, cleared and uncleared commodities, credit derivatives for noninvestment-grade entities, all equities, and any uncleared credit default swaps

  US manufacturers, including captive finance companies, can hedge risks associated with the sale or lease of their products if they are hedging for their own risks:

- **Risk retention:** Bank financial regulators and the SEC will jointly prescribe standards that require securitizers of asset-backed securities to retain 5 percent of the credit risk of each securitization. Regulators can lower this ratio if certain underwriting standards are met, but the required risk retention cannot be hedged. There is a safe harbor for qualified residential mortgage loans.

- **Interchange fee restrictions:** Under the Durbin amendment, the Federal Reserve can limit debit interchange fees to those that are "reasonable and proportional" to the transaction costs incurred, including considerations for fraud. An additional "steering" provision would permit merchants to offer incentives for the cards of their choice and discounts for cash, check, debit or credit cards. Merchants would be permitted to set minimum and maximum limits for credit card purchases.

- **Interest on demand deposits:** Banks are authorized to pay interest on corporate checking accounts, effective one year from the date of enactment.

- **Transactions with affiliates and insiders:** Treats exposure to derivatives transactions, securities borrowing and lending to affiliates as covered transactions for the inter-company limitations, reporting and other requirements of Section 23A of the Federal Reserve Act.

- **Impact of mergers on financial stability:** The "impact on financial stability" is now a condition for both banks and nonbank mergers under the Bank Holding Company Act. All Council-designated nonbank financial companies are subject to limits on bank acquisitions as if they were bank holding companies.

- **Merger 10 percent size limit:** Financial institutions would not be permitted to merge if the resulting company would control more than 10 percent of the total liabilities of all financial companies (part of the Volcker Rule).

- **Prompt corrective action:** The Federal Reserve will determine new early remediation for companies in financial distress.

- **"Grave threat to financial stability":** The Council may impose a range of corrective actions and restrictions—potentially including divestiture—on the activities of a company determined to be a "grave threat" to financial stability.

- **De novo interstate branching:** De novo interstate branching by national banks and insured state banks will be permitted, similar to branching capabilities for thrifts under current law.

- **Interstate acquisitions:** Banks and bank holding companies must be "well capitalized" and "well managed" as determined by their regulators before any interstate acquisitions are approved.

- **Federal Reserve capture:** Financial companies that received TARP funds and then subsequently de-bank would still be subject to Federal Reserve regulation and supervision. This rule has been named the "Hotel California" provision after the Eagles lyric: "You can check out anytime you like, but you can never leave.…"

- **Federal Reserve emergency liquidity powers:** Mandates that any emergency lending provided by the Federal Reserve must provide liquidity to the financial system as a whole, rather than assisting a failing entity. All such lending must be approved by the Secretary of the Treasury. Collateral must be sufficient to protect taxpayers from losses.

- **Federal Reserve Bank board directors:** Restricts bankers serving on Federal Reserve Bank boards from voting for their respective regional bank president.

- **Deposit insurance moratorium:** The current FDIC moratorium is continued on the chartering of new industrial banks, credit card banks and trust companies.

- **Hedge fund registration:** Hedge funds and private equity funds must register with the SEC; this eliminates the current private investment advisor exemption.

3) Increased mandates for firm governance

- **Annual stress tests:** The bill would require the Federal Reserve to conduct annual stress tests at banks with assets of more than $50 billion and nonbanks to determine whether they have sufficient capital to absorb losses as a result of adverse economic conditions and to publish a summary of the results. Additionally, large financial companies would need to conduct independent semi-annual stress tests and banks with assets of more than $10 billion will need to conduct annual internal stress tests. Regulators are empowered to define the form, content, and methodology for conducting the stress tests.

- **Rapid resolution plans:** Large banks must submit and update plans periodically that would guide regulators in the orderly liquidation of the firm in case of failure. These resolution plans must outline how insured banks are protected from their affiliates, corporate ownership structure, assets, liabilities, contractual obligations, cross-guarantees, major counterparties, and collateral.

- **Risk committees:** Systemically important nonbank financial companies that are publicly traded and bank holding companies with greater than $10 billion in assets must have board risk committees.

- **Executive compensation:** Compensation that is excessive or could lead to material financial loss can be deemed an unsafe and unsound banking practice, and therefore be restricted by the financial regulators. Shareholders are entitled to a nonbinding vote on the level of executive compensation.

- **SEC study of fiduciary responsibility:** The SEC will study the issue of the fiduciary responsibilities of brokers and investment advisers and propose new rules in the future.

4) "More stringent" prudential regulatory standards

- **Regulating large BHCs and nonbank financial institutions**

  The Dodd-Frank Act creates at least four different levels of companies and prudential standards, based on size and complexity, to be specified by the Council and ultimately enforced by the Federal Reserve:

1) Basic standards that apply to all regulated financial institutions

2) "Heightened standards and safeguards" for risky activities and practices, as recommended by the Council and enforced by primary regulators, including state insurance regulators

3) "More stringent" standards for all bank holding companies with total consolidated assets above $50 billion as well as any other nonbank financial institution designated by the Council, potentially including broker-dealers, finance companies, insurance companies, asset managers and others

4) "More stringent" standards "that increase in stringency" under a risk matrix to be determined by the Federal Reserve for large, interconnected firms

In order to determine the level of oversight and requirements to which large bank holding companies and designated nonbank financial institutions need to comply, the Council and the Federal Reserve will consider potential threats to the financial stability of the United States; however, there is no formal definition of systemically important institutions. The criteria to be used for determining the level of oversight ultimately will be determined by the Federal Reserve, but is likely to include the following:

- Company leverage
- Amount and nature of financial assets
- Amount and type of liabilities, including the degree of short-term funding
- Extent and type of off-balance-sheet exposure
- Extent and type of interrelationships with other significant financial institutions
- Importance of the company as a source of credit and as a source of liquidity of the financial system
- Importance as a source of credit for low-income, minority, or underserved communities
- Extent to which assets are managed rather than owned
- Nature, scope, scale, concentration, interconnectedness, and mix of activities
- Degree to which the company is already regulated by a primary regulator
- Whether the company owns a depository institution
- Nonfinancial activities and affiliations of the company, and
- Other criteria the Federal Reserve determines to be appropriate

■ **"More stringent" prudential standards for large, interconnected companies**

These standards are designed to "increase in stringency" for "large, interconnected companies," as determined by the Federal Reserve, subject to subsequent Council review. Final US standards could be more stringent than international standards being devised by the Financial Stability Board, the Basel Committee, and other standard-setters

These "more stringent" prudential standards impose new requirements in the following areas:

- Higher, and higher-quality, risk-based capital
- Liquidity
- Overall risk management

- Resolution plans and credit exposure report
- Concentration limits
- Leverage ratio
- Mandatory Board risk committees
- Contingent capital (at the discretion of the Federal Reserve, following a Council study and subsequent report to Congress)
- Increased public transparency (at the discretion of regulators)
- Short-term debt limits (at the discretion of regulators)
- Any other standard the Federal Reserve wants to impose

- **Alternative prudential standards for nonbanks:** The Federal Reserve, in consultation with the Council, can apply different but similarly stringent risk controls as an alternative to the new risk-based capital and leverage requirements, in cases where such requirements and limits are not appropriate for a nonbank's activities. This is designed to give the Federal Reserve some discretion with respect to nonbank firms such as insurance companies and asset managers.

- **"Heightened standards":** In addition to new prudential standards, the Dodd-Frank Act also empowers the Council to recommend "heightened standards and safeguards" for activities and practices that could pose a risk to financial stability. These heightened standards will be applied by the primary regulator, including state insurance regulators.

- **Minimum capital:** The legislation empowers regulators to determine new, higher minimum capital standards under the Collins amendment that will adapt as banks grow or engage in "risky" activities. Trust-preferred securities (TPS) would be excluded from Tier 1 capital calculations, although TPS for bank holding companies with under $15 billion in assets would be grandfathered. Bank holding companies with assets greater than $15 billion would have five years to comply. No new TPS would count as Tier 1 capital.

- **Additional capital requirements:** Off-balance-sheet activities will be incorporated into the computation of new capital requirements. Several new studies are mandated, including studies on the use of hybrid capital for Tier 1 calculations, foreign bank intermediate holding company capital and contingent capital. Regulators are charged with exploring ways to ensure that new capital requirements are countercyclical.

- **Leverage ratio:** The Council may impose a 15:1 debt-to-equity ratio on any company that it determines to pose a "grave threat" to US financial stability, where the imposition of the leverage limit would not increase the risk of instability. Off-balance-sheet exposures will be incorporated into the calculation.

5) Significantly higher regulatory costs for larger firms

The Dodd-Frank Act will result in increases in at least five kinds of regulatory cost:

- **Increased FDIC premiums to fund the Dodd-Frank Act:** The estimated costs to implement the Act will be recouped by raising the FDIC target reserve ratio from 1.15 to 1.35 percent of insured deposits by 2020, requiring an increase of ~$9 billion in deposit insurance premiums over that timeframe. This cost will be paid by banks with assets greater than $10 billion. The remaining costs will be recouped by "ending TARP" early, allocating $11 billion using pay-go budget scoring rules.

- **FDIC asset-based insurance premiums:** In addition to higher FDIC premiums to pay for the Dodd-Frank Act, risk-based deposit insurance will now be calculated based on total assets minus tangible equity, rather than on an assessment base of insured domestic deposits as in the past, subject to FDIC approval. Deposit insurance coverage is increased to $250,000, and the Transaction Guarantee Program is extended through 2012.

- **Future liquidation costs:** Taxpayers will not pay for the liquidation costs of large financial institutions in the future. Net liquidation costs for any nonbank financial company resolved by the FDIC will be repaid on an ex-post basis by all "eligible" financial companies and all bank holding companies with greater than $50 billion in assets. Freddie Mac and Fannie Mae are not covered under this provision, and therefore large banks and nonbanks will not have to pay any net GSE-related losses.

- **BHC examination fees:** The Federal Reserve is now empowered to charge bank holding company examination fees on top of bank examination fees by other regulators, such as OCC.

- **Council and OFR fees:** The costs of creating and funding new regulatory groups, such as the Financial Research Fund, will be paid by large financial institutions.

- **Supervisory compliance costs:** While it is impossible to quantify at this point, supervisory compliance costs will rise over the next several years as institutions comply with the hundreds of regulations that this legislation will generate; these costs will be even higher for those BHCs and nonbank firms subject to new Council oversight.

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