

financial services

Change is coming to financial services industry

BY JIM FRIEDMAN AND SPENCER LARCHE, for BizTimes

While the health care debate may be stealing the mainstream headlines, those connected to the financial services industry are still digesting the financial reforms recently proposed by President Barack Obama.

Like health care reform, change in the financial sector is definitely coming. Exactly how much change remains to be seen, but due to the pervasive view that the financial crisis of last October was caused primarily by a lack of risk oversight and control, there is one thing we can all be sure of - there will be more regulation, not less.

Obama's proposal sheds some light on the thinking of the administration. In general, it calls for increased supervi-

sion and regulation over many previously unregulated or lightly regulated financial products or services.

For example, the proposal calls for a central clearinghouse for all standardized over-the-counter ("OTC") derivatives, creates recordkeeping and reporting requirements for OTC derivatives, and imposes significant prudential regulations upon OTC derivatives dealers.

It also would require the registration of investment advisors of hedge funds and other private pools of capital, and would attempt to bring large non-bank financial institutions under the watchful eye of the government by denoting such firms as Financial Holding Companies ("FHCs").

In addition, the proposal attempts to link loan originators and sponsors to the underlying loans by requiring that they retain 5 percent of the credit risk of securitized exposures. The idea, of course, is that loan originators will make better decisions if they share a larger portion of the risk associated with the loans.

The proposal also focuses heavily on consolidating regulatory authority and managing systemic risk. To accomplish these stated goals, the administration suggests the creation of numerous government offices and agencies (e.g. the Financial Services Oversight Council, the National Bank Supervisor, the Office of National Insurance, and the Consumer

Financial Protection Agency).

Seal the cracks

These agencies will be tasked with ensuring that regulation is comprehensive and leaves no room for firms to fall between the cracks. Furthermore, the proposal grants additional power to the Federal Reserve so that it can serve as a systemic risk monitor for the financial services industry.

The proposal would allow the Federal Reserve to identify and monitor FHCs, set capital requirements, liquidity standards, and other prudential standards, and oversee systemically important payment, clearing, and settlement systems.

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While there is uncertainty over which particular changes will be enacted, it is clear that any additional regulation is likely to increase the burden particularly on banks, both large and small. However, the effect on large and small banks is not likely to be the same, as smaller institutions may have a harder time complying with new rules.

Larger, conservatively run banks are not as likely to have problems with additional regulations or new structures. They tend to be well-capitalized, avoid risky behavior, and can conform to further restrictions without too much difficulty. Most large institutions already have a sophisticated compliance and internal audit staff to monitor the institution's activities and compliance and they possess the wherewithal to hire additional professionals.

In larger institutions, audit and compliance units often function independent of the business operating units and are afforded great freedom as they oversee risk. It is also important to recognize that such institutions typically have well developed ethics and governance policies against which to judge conduct and which avoids putting them in the government's compliance crosshairs. Also, well-run banks

simply do not do the types of things that the proposal aims to restrict.

Smaller banks at disadvantage

On the other hand, smaller institutions, even though well-managed, are likely going to be hit hard by additional regulation. They often have a difficult time keeping up with the necessary steps to remain compliant with government regulations and lack the resources to hire a sophisticated compliance and audit staff. Thus, they need to resort to outside advisers and consultants at considerable expense and without a continuous oversight presence.

Unfortunately, this creates a business disadvantage for smaller banks which can be solved by selling out to a bigger bank with those resources. The added regulation can then have the unintended consequence of driving small banks out of business. These banks often fill a community niche and provide very high levels of personal service – yet the burden of government regulation can take them the way of the buffalo.

While burdensome to many, the regulations proposed in Obama's plan are unlikely to have much of an effect

on large, well-run institutions. However, small institutions may be forced to sell as increased compliance costs overwhelm the bottom line. In short, while much of the proposal is concerned with those financial institutions which are "too big to fail," the proposal itself may indirectly cause a consolidation in the industry

among smaller institutions, and whether that would be a net positive or negative remains to be seen. ■

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