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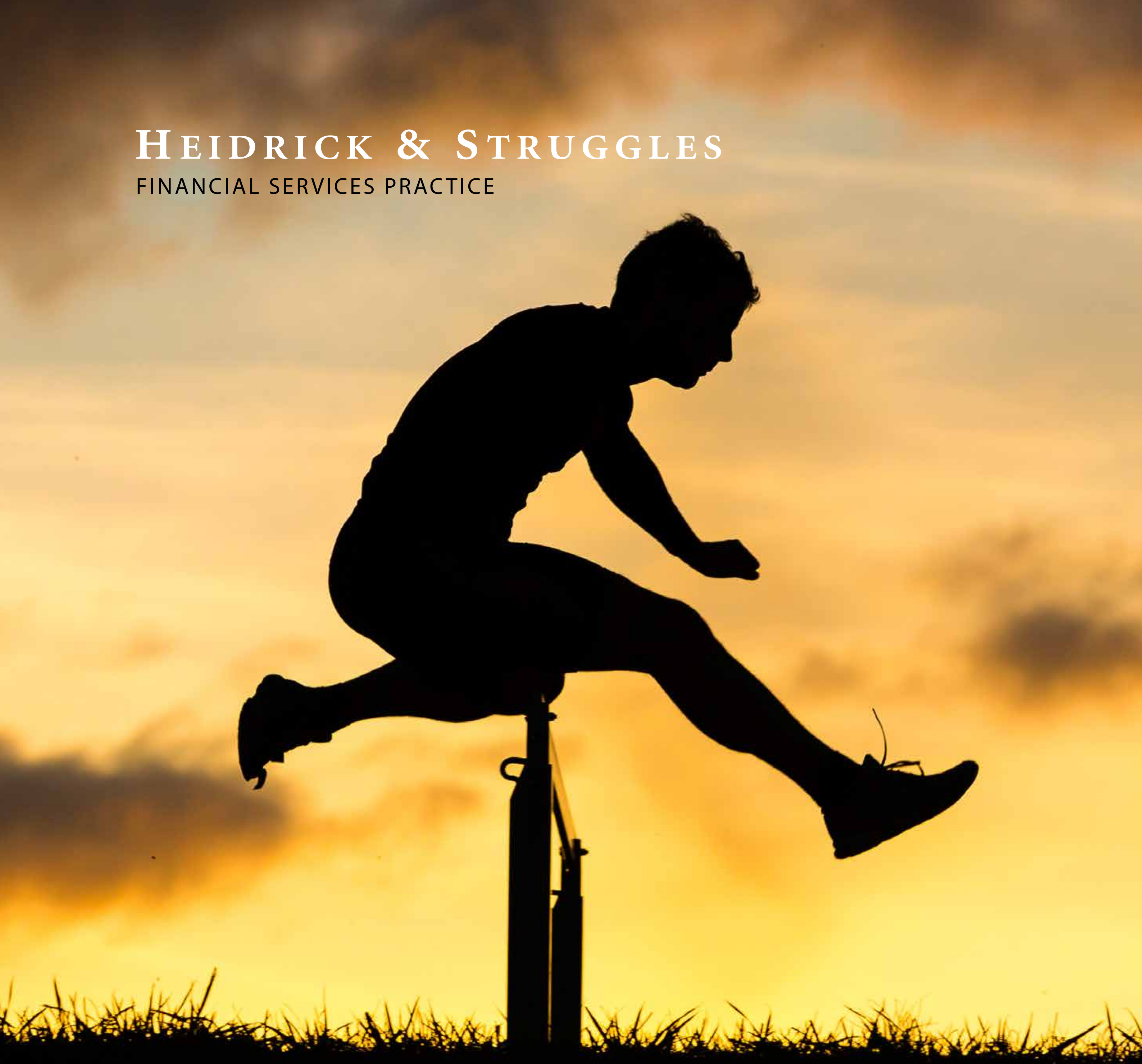
FINANCIAL SERVICES PRACTICE



Elevating regulatory strategy in financial services

New regulation is reshaping the landscape for US financial-services players, yet many of them approach regulatory strategy in a decidedly nonstrategic way. Time to stop playing catch-up.

Regulators have more power than ever to change the competitive landscape in the financial-services industry. From routine rule making to oversight to enforcement actions, regulators can render a financial product uneconomical, undercut go-to-market strategies, and induce firms to completely reassess the businesses in which they compete. Historically, firms have been reactive, treating changing regulations primarily as issues of control and compliance, not of strategy. But in a series of conversations we recently conducted with US financial-services executives and government regulators, both groups acknowledged that, in today's climate, firms must forge a stronger link between regulatory strategy and business strategy.

The words of a senior official with the US Consumer Financial Protection Bureau (CFPB) are typical of what we heard: "Interactions with regulators have changed from a legal and compliance mind-set to an advocacy and education approach. An institution that identifies and adapts to this change can use that shift to better position the firm in the marketplace."

Based on these conversations, our experience in the industry, and our experience addressing leadership issues, we believe that financial-services firms can take some simple steps to better integrate regulatory strategy with business strategy across the enterprise, use proprietary regulatory intelligence and policy insight to gain competitive advantage, and put in place mechanisms that help maintain that advantage. Such a program is not without its challenges, as we detail in this article, but firms that meet these challenges will be better positioned to stay ahead of constantly evolving regulation—and the competition.

Strategic upheaval

More stringent regulation has affected financial-services firms across the board, including consumer institutions, systemically important financial institutions (SIFIs), and investment/wealth management businesses. (For details of recent regulatory actions in each of these sectors, see the sidebar, "The beat goes on: Recent regulatory actions.") The consequences for business strategy can be sweeping:

- It was recently reported that the Office of the Comptroller of the Currency (OCC) and the San Francisco Federal Reserve were investigating whether Wells Fargo had a sales culture in place that pushed employees too hard and could result in questionable behavior. A key competitive advantage for Wells has been its ability to cross-sell across different product classes. Any attempt to rein in this approach could have a major financial impact on the bank and other institutions that have similar incentives in place.[1]

- MetLife, as a result of being designated a SIFI by the Financial Stability Oversight Council (FSOC), announced on January 12, 2016, that it would divest most of its US life-insurance business, due mainly to stricter capital levels for firms deemed systemically important. MetLife CEO Steven Kandarian said the company concluded that "an independent new company would be able to compete more effectively and generate stronger returns for shareholders . . . [and] this risk of increased capital requirements contributed to our decision to pursue the separation of the business."[2] At the same time, the company fought its "too big to fail" designation in the US Federal District Court for the District of Columbia, winning the first round in March 2016. Nevertheless, the company will proceed with the divestiture of its life-insurance business, in part because its "too big to fail" litigation could drag on for years.

- GE announced in April 2015 that it would significantly reduce the size of its lending operations, a major strategic decision that was in part based on the regulatory burden of being designated as systemically important.[3]

- AIG came under pressure from activist investors, who cited its SIFI designation as being an impediment to achieving profitability targets, to split into three companies.[4]

- In preparation for an important ruling by the US Department of Labor regarding retirement accounts, LPL Financial, an independent broker-dealer, cut prices and lowered the minimum dollar amount required to maintain an account.[5]

Given the potential for such profound strategic consequences, firms will have to reconsider the practice and positioning of regulatory strategy in their organizations as they pursue new business strategies.

What's getting in the way

First, firms will have to address a set of common conditions that impede tighter linkages between regulatory strategy and business strategy. Three challenges stand out.

Regulatory strategy is reactive

Instead of anticipating likely changes in the regulatory landscape and exploring how to plan for such developments, many firms change strategic direction only in response to new regulations, regulatory pressure, or the most obviously looming regulations. That is beginning to change. Says a high-ranking official of the US Department of the Treasury, "Some financial institutions are starting to realize the need to think about regulations at the first stage of product development. We recently had the CEO of a payments company proactively reach out to us to arrange a meeting with the Secretary to discuss their business."

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[1] Emily Glazer, "At Wells Fargo, how far did bank's sales culture go?," *Wall Street Journal*, November 30, 2015, wsj.com.

[2] Leslie Scism, "MetLife to shed big chunk of life unit," *Wall Street Journal*, January 12, 2016, wsj.com.

[3] Victoria McGrane, "GE looks to check out of 'Hotel California' of added federal oversight," *Wall Street Journal*, April 10, 2015, wsj.com.

[4] Leslie Scism, Joann S. Lublin, and David Benoit, "AIG faces push to break up," *Wall Street Journal*, October 28, 2015, wsj.com.

[5] Tariro Mzezewa, "LPL lowers minimums, cuts fees to prepare for fiduciary rule," *Reuters*, March 16, 2016, reuters.com.

The beat goes on: Recent regulatory actions

Regulation in the financial-services industry remains a moving target, with new rules and pressures emerging constantly. Here are some recent developments in three key sectors of the industry.

Consumer institutions

For consumer businesses such as auto finance, credit cards, debt collection, mortgages, and student loans, the competitive landscape has been transformed by the Consumer Financial Protection Bureau (CFPB), now in existence for more than four years.

- In 2015, for example, the CFPB doubled the number of enforcement actions brought against industry, reflecting the growth in the agency's number of investigators, examiners, and administrative staff.[1] It initiated more than 50 enforcement actions, settling most of those cases for more than $1.6 billion in compensation to consumers—more than $30 million per settlement, on average—and approximately $190 million in civil penalties.[2]

- Also in 2015, the CFPB issued a "Know Before You Owe" rule that requires mortgage lenders, title companies, and settlement agents to provide loan-disclosure documents with additional information to borrowers at least three days before closing. The rule is intended to provide consumers with more information on all fees, but in some cases it has resulted in delays and cost increases.[3] Lenders have already begun to feel the financial impact of this rule and the challenges in its implementation. Michigan-based Flagstar Bank, a savings and loan institution, cited "Know Before You Owe" as a factor in its loan sales falling $22 million, or 32%, in the fourth quarter of 2015.[4]

- In February 2016, CFPB director Richard Cordray urged banks to provide customers more access to checking accounts with overdraft protection and to aggressively market those accounts.[5] Overdraft fees are a significant source of revenue for banks. In 2015, the top three banks in the United States earned a combined $6 billion in ATM and overdraft fees.[6]

Further action likely lies ahead: CFPB enforcement director Tony Alexis told an American Bar Association conference in January 2016 that he expects the bureau to be "very active" in the coming year on issues such as debt collection, mortgage servicing, and student loans.[7]

Systemically important financial institutions (SIFIs)

- In referring to SIFI organizations, Federal Reserve governor Daniel Tarullo has said that "the goal is essentially to provide any firm that could bring down the financial system with a choice. Firms can shed businesses that the Fed considers risky or maintain the associated high capital levels."[8]

- In April 2016, the Federal Reserve and the FDIC found that the "living wills" of five SIFIs—their plans for how they would enter bankruptcy without threatening the stability of the financial system—were "not credible" or "would not facilitate an orderly resolution" under the US Bankruptcy Code.[9]

Investment/wealth management firms

- In December 2014, the Financial Stability Oversight Council (FSOC) issued a notice seeking public comment regarding potential risks to US financial stability from asset-management products and activities. Currently, the FSOC is still looking at whether the risks require actions outside the authority of the SEC, this sector's primary regulator.[10]

- The SEC is seeking to finalize new regulations on the ability of firms to assume riskier bets using derivatives and to meet withdrawal requests.

[1] Yuka Hayashi, "Consumer Financial Protection Bureau roughly doubled caseload in 2015," *Wall Street Journal*, January 11, 2016, wsj.com.

[2] Joseph Barloon, Austin Brown, Neepa Mehta, Anand Raman, and Darren Welch, "CFPB pursues aggressive enforcement agenda and arbitration restrictions," *Skadden's 2016 Insights: Financial Regulation*, January 2016, skadden.com.

[3] Daniel Goldstein, "New rules to protect home buyers starting to add delays and costs," *MarketWatch*, December 22, 2015, marketwatch.com.

[4] Flagstar Bank, "Flagstar reports fourth quarter 2015 net income of $33 million, or $0.44 per diluted share," press release, January 26, 2016, investors.flagstar.com.

[5] Yuka Hayashi, "CFPB asks banks to make low-cost accounts available to consumers," *Wall Street Journal*, February 3, 2016, wsj.com.

[6] Heather Long, "ATM and overdraft fees top $6 billion at the big 3 banks," *CNNMoney*, January 14, 2016, money.cnn.com.

[7] Jeff Bater, "CFPB's 'to do' list grows as election looms," *Bloomberg BNA*, January 22, 2016, bna.com.

[8] Ryan Tracy, Christina Rexrode, and Emily Glazer, "Not too big to fail. Too expensive to exist," *Wall Street Journal*, January 13, 2016, wsj.com.

[9] "How each bank's 'living will' plan fared with U.S. regulators," *Wall Street Journal*, April 13, 2016, wsj.com.

[10] Ryan Tracy, "Tracy's take: The asset managers' tap dance," *Wall Street Journal*, March 16, 2016, wsj.com.

Regulatory strategy is lost in the shuffle

Typically in financial-services firms, highly skilled professionals across legal, risk, compliance, audit, and government-affairs operations have regular touchpoints with regulators and policymakers. So do many executives in the firm's lines of business. However, most institutions lack one person or team that is responsible for consolidating all of this information and distilling it for business leaders. This decentralized structure, says the managing director of regulatory affairs for a systemically important financial institution, "creates silos and inhibits the coordination of strategy and processes across the enterprise." As a result, regulatory strategy remains uncoordinated, severely inhibiting its integration with business strategy. Meanwhile, business leaders who want to thoroughly incorporate regulatory strategy into their thinking must sort through all the many sources of regulatory insight throughout the organization and pull it together for themselves, something these already busy executives have little time for.

Regulatory strategy lacks stature

Although some firms have appointed executives to analyze aspects of regulatory policy, this task is often an addition to their primary responsibilities. They have neither a mandate to comprehensively consider regulation and synthesize its implications nor the clout to exert influence across the organization. Yet, as the chief risk officer for a major investment management firm told us, "There is nothing more strategic in shaping the actual outcomes for financial institutions these days than regulation, so there is a strong case for elevating this kind of role."

Taking up the challenge

As the pace and rigor of regulation continue to increase, we believe that many firms will remedy these shortcomings by establishing an enterprise-wide role for regulatory strategy. In practice, a centralized regulatory-strategy operation would:

- Serve as a clearinghouse for all regulatory insight and intelligence
- Provide unique policy insight to executive leaders based on institutional knowledge, subject matter expertise, and a strong Washington, DC, network
- Work with the business leads to ensure that regulatory expectations are part of the corporate planning process
- Partner with the business and other functional leaders (e.g., government affairs, risk, and legal) to develop a strategy for influencing regulatory policy
- Work with relevant industry associations to ensure that the firm's priorities are appropriately reflected in how the organization conducts advocacy
- Represent the company in the Washington, DC, regulatory community
- Develop a regulatory thought-leadership strategy and plan to engage third-party consumer-advocacy groups

This approach is not without its challenges. Chief among them is selecting the right leader. The role requires certain key skills and experiences that aren't always found in control functions such as compliance, audit, and risk. These indispensable skills include a deep understanding of how existing policy affects the business, how changes in policy can alter competitiveness, and how the limited resources of the institution may be used to shape a dialogue with the regulatory community and key nongovernmental stakeholders.

The role also requires a strong commercial orientation and the ability to communicate in the business vernacular used by other executives. This person must also be well networked in relevant regulatory and policy circles in Washington, DC, and have a reputation for being a respected, nonpartisan thought leader. The head of regulatory strategy should also be adept at working closely with the head of government affairs, who will remain focused on congressional outreach and will align with the regulatory leader on that outreach and messaging.

Most important, the head of regulatory strategy needs to be able to demonstrate to the business leads the value of integrating regulatory strategy with business strategy, to show them how such integration can help them get ahead of the competition, and to continue to supply them with regulatory intelligence that they can put to work.

Where can you find someone who combines all of these attributes? You might have to look externally, but it's also possible that the ideal candidate already works for the firm—in legal, government relations, public affairs, or risk. Or you might look on the business side to a strategically astute executive who already commands wide respect in the organization and has experience dealing with regulators and policymakers. Indeed, a role of this nature could become a development path for high-potential executives (see figure).

Regardless of where the regulatory-strategy leader comes from, the organization should take the following simple steps to set up the role for success.

Figure: **Look close to home**

Your next head of regulatory strategy could already be in your organization. You can help prepare high-potential executives for this role by:

- **Exposing them to Washington, DC, through ad hoc projects and in-person meetings with key stakeholders**
- **Ensuring they develop strong relationships with your government-affairs team**
- **Familiarizing them with the company's key regulatory touchpoints**
- **Seeing that they spend time with senior executives and business leaders to better understand the regulatory issues affecting the company**

Determine the right reporting relationship

When considering a critical new role, it is tempting simply to suggest creating yet another C-level position reporting to the CEO. But in this case, our experience and a fairly broad consensus among the executives we talked with argue for having the head of regulatory strategy report directly to the general counsel. Says the chief banking and regulatory counsel for a major consumer-finance organization, "You could then put the bank regulatory legal team into that regulatory-strategy team as well. That legal group would fit nicely under someone who has a complete vision and strategy for interactions with the government." There is another equally compelling reason to put the role under the general counsel: according to the managing vice president of regulatory relations for a top 10 bank, "In no way can you have this kind of role report into a first-line executive in the business. It would constitute too much of a conflict of interest, and the regulators would be concerned."

Diplomatically reassign responsibilities

Because the role of regulatory-strategy head can subsume responsibilities currently dispersed among other executives, their roles might need to be redefined. As with any redistribution of responsibilities, this should be handled with tact and with regard to the sensitivities of people who might feel that they are losing power or relevance. For example, we have seen some heads of government affairs accept the elevation of the regulatory role when it was accompanied by a clear delineation of responsibilities, internal communication regarding the role's mandate, and reassurance that government affairs remained an essential function for engaging lawmakers and other public stakeholders.

Institute a governance structure

Applying regulatory insight in ways that better serve business strategy requires thoughtful, cross-functional collaboration, decision making, prioritization, and resource allocation. Though companies may be rightly wary of creating additional bureaucracy, a regulatory-strategy committee or similar governance body helps establish a cadence in decision making and helps ensure enterprise-wide dissemination of regulatory intelligence. The regulatory committee of one of the world's leading banks includes professionals from regulatory strategy, the business units, and select functions. They conduct a weekly phone call and convene every other month to review key regulatory matters and set policy. This forum not only facilitates dialogue across the numerous business units but also ensures that there is a structure in place to make decisions on key regulatory issues.

Ensure buy-in from the organization

A leader who commands wide respect and can demonstrate the value of regulatory intelligence can go a long way toward gaining the confidence of business leads. But unless the CEO unequivocally supports the mission of the regulatory-strategy leader, pockets of resistance or indifference are likely to remain and undermine the effort in the long term.

■ ■ ■

Firms that select the right regulatory-strategy leader and set the stage for success in the role will be able to close the gap between foreseeing and interpreting regulatory-policy changes in Washington, DC, and conveying valuable insights to busy executives. They will be able to engage regulators, lawmakers, and nongovernmental organizations in far more productive dialogue about major issues. And they will be able to influence regulatory policy more strategically and effectively and to more broadly shape a public narrative. Most important, with billions of dollars at stake and regulation expected to dominate strategic decisions for years to come, they will be able to transform regulatory burdens into business opportunities. ■

About the authors

Paul Gibson (pgibson@heidrick.com) is a partner in Heidrick & Struggles' New York office and a member of the Financial Services Practice.

Jared Oren (joren@heidrick.com) is an associate principal in the Washington, DC, office and a member of the Financial Services Practice.

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Leaders of Heidrick & Struggles' Financial Services Practice

David Boehmer
Global Practice Managing Partner
dboehmer@heidrick.com

Jenni Hibbert
Practice Leader, UK
jhibbert@heidrick.com

Dan Ryan
Regional Managing Partner, US
dryan@heidrick.com

Frazer Wilson
Regional Managing Partner,
Asia Pacific and Middle East
fwilson@heidrick.com

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