

Global Financial Crisis Bulletin

“Oil and Water”? Differences Between Investment Banking and Commercial Banking Supervision

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“Investment Banks and Commercial Banks are Analogous to Oil and Water: They Just Do Not Mix.” Such is the title of a paper by Kevin LaRoche, a Boston University student.¹ The author bases his view on the fact that investment banks are not financial intermediaries. They do not take deposits and lend them out, so default risk is not a concern for them. Rather, they earn their fees from issuing securities and their financial reward is not tied to the future success or failure of the issuers. This, he argues, makes investment banks much more risk tolerant than commercial banks, resulting in a culture clash akin to mixing oil and water. In the current environment, one cannot help but wonder whether those investment banks (and potentially other companies) that opt to become bank holding companies or financial holding companies will also conclude that the difference between their former and current regulators is also like oil and water.

The first hint that this might be the case can be found in a comparison of the mission statements of the U.S. Securities and Exchange Commission (SEC) and the Federal Reserve Board (FRB). The SEC’s stated mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”² The FRB describes its duties, in part, as follows:

- Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers.
- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.³

These different mandates – the SEC’s protection of investors and the FRB’s protection of the financial system – no doubt have influenced how the SEC and FRB approach their supervisory responsibilities. Some have even argued that these contrasting missions produce staffs and internal cultures indicative of their missions – the SEC hires more attorneys, while the FRB hires more economists.⁴

Anyone who doubts that the FRB and the SEC have different approaches need only look back to the early days of Section 20 subsidiaries.⁵ In the late 1980s, when the FRB authorized limited securities underwriting authority for bank holding companies, many bank holding companies opted to acquire existing broker-dealers rather than form de novo businesses. These acquisitions occurred at nearly the same time that the FRB and the Office of the Comptroller of the Currency (OCC) launched major

¹ “Investment Banks and Commercial Banks Are Analogous to Oil and Water: They Just Do Not Mix,” LaRoche, Kevin, undated, available at http://econc10.bu.edu/Ec341_money/Papers/LaRoche_paper.htm.

² <http://www.sec.gov/about/whatwedo.shtml>

³ <http://www.federalreserve.gov/aboutthefed/mission.htm>

⁴ “The Compliance Function in Diversified Financial Institutions,” The Financial Services Roundtable, July 2007.

⁵ A Section 20 subsidiary is a subsidiary/affiliate of a commercial bank that is permitted to conduct limited investment banking activities; named after a section of the Glass-Steagall Act relating to securities underwriting, these companies were first authorized by the Federal Reserve in 1987. The need for these subsidiaries was largely obviated with the passage of the Gramm-Leach-Bliley Act in 1999.

risk-based supervision initiatives, which included specific examination modules for helping examiners assess and evaluate the management of risk in the organizations they regulated. During initial examinations by FRB examiners, management of acquired broker-dealers were often shocked to find that the way they historically had been managing their operations, which had been satisfactory to the securities regulators, fell far short of FRB expectations.

Following these initial examinations, many of these acquired companies found themselves scrambling to develop and implement more formal policies and procedures, improve their risk management and governance frameworks, and implement more rigorous compliance review and audit programs.

By the early 2000s, securities regulators also were talking about a more risk-based approach to supervision, though many would argue that this was not evident in their examinations. It is true, nonetheless, that two decades have passed since those early Section 20 companies began conducting business. Over this time, risk management practices in investment and commercial banks have evolved to eliminate some of the differences. Still, the new adopters of bank holding company or financial holding company status and their subsidiaries will need to adapt to significant changes in the way they will be regulated. There are, to be sure, a host of new laws and regulations with which they will need to become familiar and comply. These include but are not limited to: stricter capital requirements, prohibitions and/or restrictions on the nature of activities that can be conducted, restrictions on the type and volume of investments they may make, and restrictions on affiliate transactions, not to mention a plethora of consumer protection requirements and other obligations, such as the Community Reinvestment Act, that apply to insured depository institutions.

New laws and regulations per se are just the beginning of the changes for which these companies must prepare. The bigger adjustment may come in understanding and addressing regulatory expectations that have developed and evolved over the years and are documented in numerous examination manuals and regulatory issuances and/or have become expected practice, though undocumented.

Rightly or wrongly, bank supervision in the United States is as much about how the regulators perceive risk and a company's ability to manage that risk as it is about laws and regulations. In its recently released SR 08-9/CA 08-12⁶, the FRB provides additional insight into its supervisory philosophy. New bank holding companies may be particularly interested in the following points:

- Large, complex bank holding companies can expect a continuous supervisory presence; this is consistent with how the OCC and FRB have supervised large banking organizations since the mid-1980s, but something that the SEC has piloted only recently in a few institutions.
- The FRB will take an enterprisewide view of risk, and as such its scrutiny will extend beyond banking activities to nonbank subsidiaries to ensure that they do not present material financial, legal or reputational risk to the insured depository institution.
- Companies with core clearing and settlement operations will be reviewed closely because of the potential systemic risk posed by disruption to these operations.
- The bank holding company's source of strength to support its insured depository institution(s) will be critically evaluated.

Boards of directors and senior management of newly designated bank and financial holding companies will need to revisit and challenge how they do business in a wide range of areas including, but certainly not limited to:

- Balance sheet management strategy, including the employment of financial leverage, the management of capital structure and the future level of balance sheet transparency

⁶ "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations," SR 08-9/CA 08-12, October 16, 2008, available at www.federalreserve.gov.

- Funding and liquidity management strategies, taking into account systemic implications
- Financial asset quality and its relationship to capital adequacy
- New product/service development and delivery practices
- Operational risk management, including nonfinancial reporting control across middle and back offices
- Cross-border transactions and business relationships
- Regulatory compliance management and review
- Internal audit
- The role of the board of directors and senior management in risk management

For some new bank holding companies, transitioning to an FRB supervisory regime may require adding people to the organization's risk management and governance structure and/or changing the mindset of the organization to deal with the regulator's expectation that business is not conducted until all of the risks have been considered and addressed.

Some boards of directors and management teams also may learn that when their practices do not measure up to regulatory expectations, regulators are not shy to prescribe very specific remediation steps. Witness any number of bank regulatory enforcement actions that detail the actions that must be taken and compare these to the enforcement actions of securities regulators, which typically focus on explaining the nature of the offense but are fairly silent on the steps that should be taken to prevent a reoccurrence.

In addition, some companies may learn that the cost of noncompliance is more expensive as a commercial bank than it is as an investment bank. For example, much was written in 2007 when the NASD levied the largest-ever money laundering fine against a U.S. broker-dealer. That \$3 million fine pales in comparison to the numerous fines in the tens of millions of dollars that have been imposed on commercial banking organizations.

Certain new bank or financial holding companies may say that they are already familiar with the requirements of the bank regulators since they owned special purpose banks for many years. The biggest, but not the only, fallacy with that argument is that some of these companies have vaulted right into the big leagues and now rank among the largest bank holding companies in the country, which makes these organizations front-and-center supervisory priorities for the FRB. This significantly raises the bar from a supervisory standpoint, and does not even consider the possible new requirements arising from the inevitable legislative fixes that will be considered by a new Congress in 2009.

Becoming a bank holding company comes with a price that includes a more engaged (and some would say more intrusive) regulator with firmly held views on what risks are acceptable for financial institutions and how these risks should be managed on an enterprisewide basis.

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