

## At A Glance

# Responding to Changes to the Financial Supervision Playing Field

## Overview

Financial market participants have recently witnessed the destructive potential of systemic risk—now they must prepare for the government response. Under proposed legislation, certain financial institutions will for the first time become subject to Federal Reserve consolidated supervision, examination, and capital requirements. Other firms, currently operating under some form of financial regulatory regime, are likely to find themselves under closer scrutiny by the Federal Reserve or other regulators.

According to the US Treasury's Financial Regulatory Reform Plan, any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability should be subject to robust consolidated supervision and regulation, regardless of whether the firm owns an insured depository institution. These yet to be identified, Tier 1 Financial Holding Companies (FHCs) will certainly include major insurance companies and large hedge funds. The list could also include other asset management firms and even traditional industrial companies with significant financial arms. If not deemed a Tier 1 FHC, financial firms are still likely to face the demands of a new Consumer Financial Protection Agency, and more empowered prudential and/or legal entity regulators.

Meeting these new, heightened regulatory expectations while remaining focused on sustaining a profitable business will be a key challenge for boards of directors and senior managers of major financial firms over the next few years.

## Capabilities

NERA provides guidance to financial firms in order to ensure that the challenges associated with oversight by the Federal Reserve and others are successfully met. Firms that are required to meet myriad Federal Reserve risk-oriented regulations often lack the experience necessary to effectively design new or update existing systems, models, and reporting to meet regulatory expectations. NERA works with clients to ensure they are in full compliance with regulatory expectations while simultaneously maximizing the usefulness of required processes within the business context.

- Many current capital and other risk-oriented requirements, including trading book and credit capital rules, require the use of internal models and related data. NERA's experts provide advice and training with respect to appropriate design and implementation of model-based rules and regulations.
- NERA experts perform pre-assessments of business lines and/or functional risk areas prior to Federal Reserve or other supervisory examinations. These reviews can help firms not only to implement key

enhancements to improve examination results, but also to inform management of industry best practices in risk management.

- NERA aids clients with post-examination assistance as firms undertake efforts to respond to regulatory direction. An inappropriate response to a regulatory response or one that doesn't help optimize the business results can be very costly.

For financial firms that have received satisfactory internal and regulatory assessments to date, NERA provides highly qualified and fully independent assessments of enterprise-wide risk management processes, or designated market, credit, or operational risk processes.

## Client Experience

### **Benchmarking Credit Risk Management Practices**

NERA was commissioned by an international bank to complete a global industry benchmarking project on the application of credit risk management to hedge fund counterparties by major commercial and investment banking competitors. The bank wanted to identify industry best practices and areas to improve within its own procedures. NERA reviewed resource commitments to credit risk management, the efficiency of different systems, and management reporting arrangements. The project assessed potential future exposure methods with inputs such as confidence limits, stress testing, data series, portfolio vs. sum of trades, and dynamic vs. static calculations.

### **Assessing Value at Risk for Quantitative Investment Strategies**

A major mutual fund family asked NERA to provide a risk assessment of several alternative investment strategies that they were considering offering to their clients. NERA used the Monte Carlo method and historical simulation techniques to measure Value at Risk and other downside risk measures for the strategies individually and combined in various portfolios. The risks of these strategies were evaluated over a diverse set of market conditions and stress scenarios. NERA also reviewed the risks posed by leverage in the strategies, and suggested ways to manage the liquidity, funding, and execution risks if the strategies were implemented.

### **Limiting Potential Regulatory Risk**

A merchant energy firm engaged NERA to examine the trading activity of a specific group of traders who had recently joined their firm. Even though no complaints had been received and the firm had not been contacted by regulators, the firm was concerned that the group's trading was exposing them to potential regulatory risk. NERA evaluated the group's trading, identified any trading activity that could be viewed as suspect, and suggested trading limits that could limit potential regulatory risk while still allowing the group to trade effectively.

### **Benchmarking Global Operational Risk Management Practices**

A NERA team conducted a global benchmark of the operational risk management practices and trends for the top financial institutions worldwide, including their approaches to identifying, measuring, monitoring, and managing operational risks. The results of this study were presented to global regulators, including the Basel Committee's Risk Management Group, and customized benchmarks were prepared for and presented to participating institutions. The results of the study were later updated to include emerging best practices among the top institutions, including the development of internal capital allocation models and risk transfer practices.

## About NERA

NERA Economic Consulting ([www.nera.com](http://www.nera.com)) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. With its main office in New York City, NERA serves clients from more than 25 offices across North America, Europe, and Asia Pacific.

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