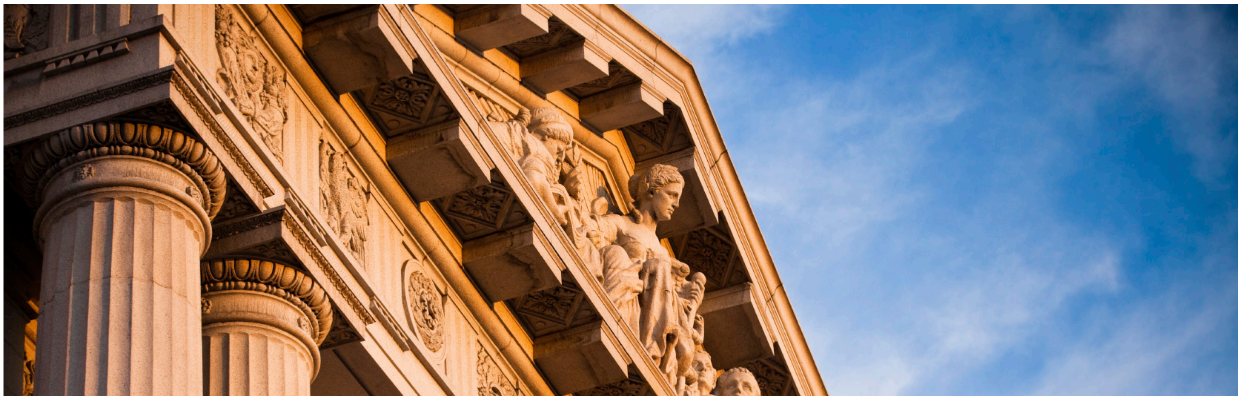
Top 10 hot topics for 2013
A mid-year outlook on the regulatory landscape for financial institutions



Financial institutions are facing a regulatory world where new rules and requirements—and even new agencies—seem to be emerging constantly. Regulators are raising their expectations—as they put institutions under an even brighter spotlight. In this challenging environment, what issues should you be aware of? And which policies will have the greatest impact on your organization now and down the road?

While your organization is probably dealing with more than what's listed here, we've put together high-level thoughts of the "top 10" regulatory policies, activities, and trends you should likely have on your radar.

The top 10 topics, in no particular order, are:

1. The significance of "getting to strong" risk management
2. The impact from regulatory arbitrage
3. The emergence of the Consumer Financial Protection Bureau (CFPB)
4. How the consolidated audit trail (CAT) will impact broker-dealers
5. The implications of money-market mutual fund reforms on banks
6. The effect of proposed enhanced prudential standards on foreign banking organizations (FBOs)
7. The evolution of resolution planning for global systemically important financial institutions (G-SIFIs)
8. The spotlight on data quality to better monitor risk
9. A renewed focus on leveraged lending
10. Increased cyber threats

1. The significance of "getting to strong" risk management: Regulators are turning up the heat on financial institutions to improve their risk management programs. This push for excellence is called "getting to strong." But few details exist for banks on how to do it.

U.S. financial regulators have raised their expectations when it comes to institutions strengthening their risk management programs. While regulators have issued previous guidance on this topic that remains in effect, the new push for excellence has its own tag line, "getting to strong." However, it's not just about achieving an overall strong rating from regulators; more importantly, it's about giving management the ability to build and maintain a robust risk management framework.

Regulators want institutions to implement a strategy in which their boards and senior management are able to frequently evaluate four main elements: governance; policies and procedures; internal controls; and measuring, monitoring, and reporting progress.

Regulators may want to see these steps flow seamlessly throughout the organization—from "tone at the top" all the way through the audit, risk, and compliance functions. Governance defines goals and expectations. Policies and procedures outline how the company should operate. Internal controls periodically address how everything should stay according to plan. Progress is measured, monitored, and reported back into the organization and adjustments are made, leading to continuous improvement. Together, these approaches begin to form a self-contained, self-renewing ecosystem.

2. The impact from regulatory arbitrage: Inconsistent application of regulatory requirements across jurisdictions creates potential risks within the global financial system, but also offers hidden opportunities for individual players and markets.

Because of the many cross-border regulatory issues they must deal with, global financial institutions now contend with inconsistent guidance from different regulators in the various jurisdictions where they do business. For example, institutions that have significant businesses in major markets, such as New York and London, might be treated differently by the regulators within those particular jurisdictions. This can result in possible loopholes—and potential risks. Plus, some institutions may get caught in the middle of turf wars between regulatory agencies and also have to deal with mixed messages.

3. The emergence of the Consumer Financial Protection Bureau (CFPB): Changing leadership and continued focus on consumer products may create limitations for market participants.

After much debate, the United States Senate confirmed Richard Cordray as the head of the CFPB. In addition, other key positions including, the chief operating officer and chief of staff and assistant director for the Office of Older Americans were also named. While this marks the end of "temporary" leadership, several questions remain and the turnover issue continues to create uncertainty and limitations on the financial industry. This has not, however, changed the continued, expanding nature of the agency and its actions.

Since opening its doors two years ago, the CFPB has acted against financial institutions for actions, products, and services it deemed harmful to consumers. The result has been millions of dollars in penalties against institution of all sizes—and the bureau continues to release new guidelines aimed at further protecting consumers. The CFPB also has been busy on fronts related to transparency. In fact, as of March 2013, the CFPB had received and released more 90,000 consumer complaints about mortgages, credit cards, bank accounts, student loans, consumer loans, and credit reports.[1]

Many of the new rules and guidance (e.g., overdraft fees, "ability-to-pay" underwriting guidelines, mortgage servicing and pay day loans) are likely to limit revenue opportunities for banks, many of which may already are struggling to find new (or increased) revenue streams.

The industry remains pensive and will wait to see what the now-permanent CFPB director will focus on for the rest of 2013 and beyond.

4. How the consolidated audit trail (CAT) will impact broker-dealers: A new regulatory reporting system will likely require broker-dealers to make significant changes to their systems and operations.

The SEC's proposed CAT system, which would help regulators better monitor and analyze trading activity across U.S. equities and options markets, is expected to have a broad impact on broker-dealers. Under this proposal, which covers all market participants across multiple asset classes, a central database will be developed to capture 58 billion records[2] daily, including orders, quotes, executions for equities, and options. It will also maintain data on more than 100 million customer accounts[3] and their associated particular customer information.

[1] Source: http://files.consumerfinance.gov/f/201303_cfpb_Snapshot-March-2013.pdf

[2] "SEC Rule 613: Consolidated Audit Trail (CAT) RFP Process, RFP Questions and Responses," CAT NMS Plan Participants, July 25, 2013, http://catnmsplan.com/web/groups/catnms/@catnms/documents/appsupportdocs/p229433.pdf

[3] Ibid.

As a result, broker-dealers will likely need to make significant changes to certain areas of their equities and options trading systems, including client onboarding, customer master data, trade order management, data storage, and internal control policies and procedures. Plus, CAT may increase the complexity and cost of regulatory compliance.

While CAT is still three years away from being implemented, some organizations are taking steps to prepare now. For example, they are assessing how to consolidate data sources to comply with regulatory reporting. They may also be creating an implementation plan to develop and test new or updated systems.

5. The implications of money market mutual fund changes on banks: Changes that would create a floating share price could potentially shift money market fund investments to the banking system.

For many individuals and corporations, money market mutual funds, which represent several trillion dollars in U.S. assets, act as cash management vehicles. The SEC has recently proposed changes that would end the practice of letting many of these funds keep a $1 daily value. Instead, the agency is proposing that the value be allowed to fluctuate a bit every day. However, many individuals and corporations are opposed to a fluctuating net asset value (NAV) for what they think of as "cash."

If money market mutual funds are considered less safe due to shifting asset values, then it's very likely funds will flow to the banking sector. However, it's unclear at this time how the SEC plans to proceed. A final decision is likely a year or longer away. And even if the SEC does adopt this change, there will be a two-year transition date for a floating NAV, which will likely provide market participants with an opportunity to adapt their strategy.

6. The effect of proposed enhanced prudential standards on FBOs: New regulations could have a significant impact on their U.S. operations, affecting their governance, operating structures, capital, and funding.

After a decade in which the Federal Reserve Board's supervisory approach to FBOs has remained virtually unchanged, the proposed enhanced prudential standards rule—as mandated by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)—introduces sweeping changes to their U.S. operations.

If adopted, the proposed rule's most significant impact would be to mandate the structural form of the U.S. operations of FBOs, and to define the capital and liquidity requirements that will be applied at the organizational level in the United States. As a result, FBOs may be required to inject significant additional captive capital and funding—and to enhance their processes and infrastructures, such as data, modeling, and reporting systems, to meet different standards.

This also means that FBOs would likely need to comply with many of the same proposed regulations that large U.S. banking organizations must follow (or will be expected to follow once the domestic enhanced prudential standards are finalized)—creating parity between the two.

7. The evolution of resolution planning for G-SIFIs: International regulators are continuing to work on effective strategies for the orderly failure of financial institutions to guard against a systemic impact.

After the economic events of 2008-2009, G-SIFIs have been required to develop resolution plans for their orderly dissolution in the event of a potential financial distress or failure. The Financial Stability Board (FSB) has been instrumental in developing an international standard—Key Attributes of Effective Resolution Regimes for Financial Institutions—that specifies the core elements considered necessary for an effective resolution regime. Authorities around the world are continuing to develop resolution strategies and operational plans for G-SIFIs and to introduce resolution powers and tools consistent with FSB's standard.

With the adoption of the Dodd-Frank Act, the US made substantial headway in requiring institutions to develop and submit detailed annual resolution plans. Similar developments and refinements have been made in other countries, including Australia, France, Germany, Hong Kong, the Netherlands, Spain, Switzerland, and the UK.

Additional legislative measures, such as the European Union's proposed Recovery and Resolution Directive, will facilitate cross-border cooperation and recognition of resolution measures to make them operational.

The FSB will also launch a process for assessing the resolvability of each G-SIFI by a group of high-level policymakers from the G-SIFI's home and key host authorities. Finally, resolution plans are being mandated for non-financial institutions, including insurers and securities and investment firms. Developing an effective strategy for the orderly failure of a systemic financial institution continues to be important, and resolution planning is likely to continue to play a major role in the financial community.

8. The spotlight on data quality to better monitor risk: Regulatory activities point to an increasing emphasis on data quality to help financial institutions improve their risk management functions.

U.S. and global regulators are increasingly stressing the importance of data quality to help financial institutions better monitor risk. For example, regulators expect that banking leaders will have the ability to aggregate and analyze relevant data so they can identify risk exposure more efficiently and effectively across the enterprise. Similarly, stress testing and recovery planning rules require leaders to perform risk monitoring exercises that help them better understand the areas of their business that need to be modified or diversified to survive periods of severe stress.

Regulators recognize the critical role of an institution's internal audit function to verify the completeness and accuracy of reportable and auditable data. In addition, they expect institutions will implement sound data management practices to promote transparency around the handling of data sources and the models that contribute to management assertions and regulatory responses.

9. A renewed focus on leveraged lending:
Regulators have become increasingly concerned about deteriorating underwriting practices as leveraged lending has grown over the last 10 years and accelerated following the financial crisis.

The Federal Reserve Board, Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation together recently issued new guidance on leveraged lending due to its growth in volume over the last decade. Regulators are concerned that prudent underwriting practices have deteriorated while exposure to leveraged loans has increased.

This new guidance, which applies to institutions supervised by the three agencies, became effective May 21, 2013 and replaces similar guidance from April 2001. The 2001 guidance dealt with broad risk management issues; whereas, the revised guidance narrowly defines the following aspects for inclusion in an institution's risk management framework, as they relate to leveraged lending activities.

- Sound risk-management framework
- Underwriting standards
- Valuation standards
- Pipeline management
- Reporting and analytics
- Risk rating standards
- Stress testing

This new guidance is evidence of an elevated focus by the agencies to ensure safe-and-sound leveraged lending practices, and it is expected to play a prominent role in their risk management framework assessments. Therefore, affected intuitions should incorporate the factors above into their risk management framework.

10. Increased cyber threats:

Over the last several years, cyber threats to the financial sector have dramatically increased. Institutions should now focus on the prevention and response to such attacks.

During 2012, more than a dozen financial institutions experienced sustained and persistent cyber-attacks that disrupted online access to consumer websites. Such attacks can severely impact the confidentiality, integrity, and availability of information and operations, resulting in devastating consequences for banks: financial losses; risks to the brand and reputation; impacts to operations; loss of intellectual property; high remediation costs; and regulatory investigations. Plus, cybercriminals may also exploit the system's users through ACH systems, card payments, and market trades.

U.S. banking leaders are urging the Federal Reserve to take the lead in defending the financial services industry from cyber-attacks. They want the Federal Reserve to act as an intermediary among the banking community, regulators, and counterterrorism, intelligence, and law enforcement agencies to promote better information sharing about threats. For example, they want the Federal Reserve to create a central repository of information on such attacks. They also want the Federal Reserve to provide financial expertise to the FBI and Department of Homeland Security because it has the ability to share sensitive information without jeopardizing commercially sensitive data.

Many leading banks are taking steps to maintain their strength and resilience amid potential cyber-attacks. These measures include better cyber-security education for employees and consumers to improve protection, mitigation, and response. In addition, they are considering program testing to drive further improvements in those areas. Cross-sector cooperation with other key industries, such as energy, power, and telecommunications, may also be critical to the resiliency of financial institutions.

Go further

These regulatory issues will likely have a profound impact on your organization in the months and years to come. And while you may have already started taking action on some of these issues, there will surely be a lot more to learn and do as the regulatory landscape evolves.

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