cutting through complexity

Ten Key Regulatory Challenges

Facing the Financial Services Industry in 2016

The complexities of the current regulatory environment undoubtedly pose significant challenges for financial institutions, as regulators continue to expect management to demonstrate robust oversight, compliance, and risk management standards. Regulatory mandates, such as the Federal Reserve Board's Enhanced Prudential Standards Rule and the Office of the Comptroller of the Currency's Heightened Standards, and other stakeholder demands, such as those stemming from customers, investors, and counterparties, are not likely to subside in the foreseeable future, but rather, will likely only be augmented by unforeseen ones. Although these challenges are particularly pressing for the largest, most globally active firms, including insurance companies under the supervision of the Federal Reserve Board, smaller institutions are also struggling to optimize their business models and infrastructures in order to address this growing scrutiny and pressure. The following are some of the key regulatory issues that are impacting our clients.

1 Strengthening Governance and Culture

Despite heightened attention from regulators and organizations to strengthen governance structures and risk controls frameworks across the financial services industry, instances of misconduct (i.e., professional misbehavior, ethical lapses, and compliance failures) continue to be reported with troubling frequency. Regulators have come to see shortcomings in the prevailing industry culture as the root cause for this continued misconduct and are looking to boards of directors and senior management to push organizations toward cultural and ethical change. Boards and senior management are now expected to champion the desired culture within their organizations, to establish values, goals, expectations, and incentives for employee behavior consistent with that culture, and to set a "tone from the top" by exhibiting their commitment to the stated values and expectations through their own words and actions. Line and middle managers, who are frequently responsible for implementing organizational changes and strategic initiatives, and who interact daily with staff, are expected to be similarly committed to adopting and manifesting the desired organizational culture by ensuring the "mood in the middle" reflects the "tone from the top." The regulatory focus also extends to how organizations implement their business strategies. Regulators expect firms to place the interests of all customers (retail and wholesale) and the integrity of the markets ahead of profit maximization. Further, they will consider the business practices organizations utilize and the associated customer costs relative to both the perceived and demonstrable benefit of a product or service to the customer. Regulators are looking for organizations to conduct business in the "right" way—doing what they "should" rather than what they "can."

2 Improving Data Quality for Risk Data Aggregation and Risk Reporting

Although a long-standing industry problem, many financial institutions continue to struggle with improving their risk data aggregation, systems, and reporting capabilities. Banking organizations working to comply with the Basel Committee on Banking Supervision's Principles (BCBS 239) are particularly pressured, as regulators continue to lack confidence in the industry's ability to produce accurate information on demand. However, enhanced process controls, data tracing, and risk reporting requirements are also top of mind for broker-dealers and investment banks under the Securities and Exchange Commission's (SEC) purview. Similarly, anticipated requirements, such as the pending single-counterparty credit limit (SCCL) rule, which would likely require organizations to track and evaluate aggregate exposure to a single counterparty across the consolidated firm on a daily basis, further fuel the industry's data concerns. Quality remains an ongoing challenge, with data integrity continually compromised by outmoded technologies, inadequate or poorly-documented manual solutions, inconsistent taxonomies, inaccuracies, and incompleteness. For insurers in particular, legacy actuarial and financial reporting systems will struggle to handle upcoming changes in regulatory reporting, new accounting pronouncements, enhanced market opportunities, and increasing sources of competition. Going forward, management will need to consider both strategic-level initiatives that facilitate better reporting, such as a regulatory change management strategic framework, as well as more tactical solutions, such as conducting model validation work, tightening data governance, and increasing employee training. By implementing a comprehensive framework that improves governance and emphasizes higher data quality standards, financial institutions should realize more robust aggregation and reporting capabilities, which, in turn, can enhance managerial decision making and ultimately improve regulatory confidence in the industry's ability to respond in the event of a crisis.

3 Merging Cybersecurity and Consumer Data Privacy

Cybersecurity has become a very real regulatory risk distinguished by increasing volume and sophistication. Financial institutions in the United States and around the world, as well as their third-party service providers, are on alert to identify, assess, and mitigate cyber risks. Failures in cybersecurity have the potential to impact operations, core processes, and reputations, but in the extreme can undermine the public's confidence in the financial services industry as a whole. Financial institutions are increasingly dependent on information technology and telecommunications to deliver services to their consumer and business customers, which, as evidenced by recently publicized cyber hacking incidences, can place customer-specific information at risk of exposure. Some firms are responding to this linkage between cybersecurity and privacy by harmonizing their approach to incidence response for each of the two areas. Protecting the security and confidentiality of customer information and records is of paramount concern to institutions and regulators alike, as reflected in their business and supervisory priorities for the coming year. A recent U.S. court case has affirmed that the Federal Trade Commission (FTC) has authority to regulate a company's cybersecurity practices under its unfair and deceptive acts or practices (UDAP) provisions and to undertake enforcement actions related to the security and privacy of consumer data. Through its participation in the Federal Financial Institution Examination Council's (FFIEC) 2015 Cybersecurity Assessment Tool and its supervisory authority over consumer privacy laws and regulations, the Consumer Financial Protection Bureau (CFPB) may, in time, show similar interest. Areas of regulatory concern related to privacy may include: data access rights and controls; data loss prevention; vendor management; training; and incident response.

4 Accomodating the Expanding Scope of the Consumer Financial Services Industry

The CFPB has exercised its authorities prohibiting financial companies (bank and nonbank) from engaging in UDAAP (unfair, deceptive, or abusive acts or practices) very broadly, placing some companies that operate beyond the traditional financial services arena within its purview. In particular, the CFPB has initiated actions against nonbank auto finance companies, consumer goods retailers, post-secondary educational institutions, and telecommunications companies for practices associated with the financial products and services they offered their customers, including extensions of credit and third-party payments processing. For such cases, the CFPB has sought both civil money penalties and restitution for harmed consumers; where appropriate, it has partnered with other nonbank federal regulators, such as the FTC and the Federal Communications Commission. The CFPB has boldly pushed forward on the boundaries of the traditional definitions for providers of consumer financial services and there is every reason to anticipate that it will continue to do so to carry out its mandate to protect consumers from financial harm by ensuring that the consumer financial markets are fair, transparent, and competitive. Areas to watch going forward might include: accounting, tax preparation, and law firms involved in refund anticipation loans and similar products; nonfinancial companies that provide third-party payments/billings processing to their customers; providers of retirement savings and benefit loans; and marketplace lenders. Insurance consumer risks are also in the spotlight, and U.S. insurance regulators, influenced by the CFPB, are now examining for this risk.

5 Addressing Pressures from Innovators and New Market Entrants

The financial services industry, including the insurance sector, is experiencing an increase in financial activity that encompasses the availability of new products and services introduced to meet a growing demand for efficiency, access, and speed. Broadly captioned as Financial Technology, or FinTech, innovations such as Internet-only institutions, virtual currencies, mobile payments, crowdfunding, and peer-to-peer lending are changing traditional banking and investment management roles and practices as well as risk exposures. The fact that many of these innovations are being brought to market outside of the regulated financial services industry—by companies unconstrained by legacy systems, brick-and-mortar infrastructures, or regulatory capital and liquidity requirements—places pressures on financial institutions to compete for customers and profitability, and raises regulatory concerns around the potential for heightened risk associated with consumer protection, risk management, and financial stability. Regulators will be watchful of the key drivers of profit and consumer treatment in the sale of new and innovative products developed within and outside of the regulated financial services industry, and will separately seek appropriate regulatory regimes to capture the risks posed by new products and services while remaining cautious not to stifle innovation or limit credit availability.

6 Transforming the Effectiveness and Sustainability of Compliance

Compliance continues to be a top concern for organizations as the pace and complexity of regulatory change, coupled with increased regulatory scrutiny and enforcement activity, have pushed concerns about reputation risk to new levels. Organizations need to be able to respond to changes in their internal and external environments with flexibility and speed in order to limit the impacts from potentially costly business shifts or compliance failures. To do so, however, can demand enhancements to the current compliance management program that: build adaptability into the inter-relationships of the people, processes, and technologies supporting compliance activities; augment monitoring and testing to self-identify compliance matters and expand root cause analysis; and, integrate compliance accountability into all facets of the business. Compliance accountability starts with a strong compliance culture that is supported by the "tone from the top" and reaches across all three lines of defense, recognizing that each line plays an important role within the overall risk management governance framework. Transforming compliance in this way allows compliance to align on an enterprise-wide basis with the organization's risk appetite framework, strategic and financial objectives, and business, operating, functional, and human capital models.

7 Managing Challenges in Surveillance, Reporting, Data, and Control

Driven largely by regulatory requirements and industry pressures for increased speed and access, trade and transaction reporting has become increasingly complex. Capturing and analyzing vast amounts of data in real time remains a massive challenge for the financial services industry, as regulators continue to initiate civil and criminal investigations and levy heavy fines on broker-dealers, investment banks, and insurance companies based on failures to completely and accurately report required information.

In addition, ensuring compliance with federal and state laws prohibiting money laundering, financial crime, insider trading, front running, and other market manipulations and misconduct remains critically important. In the coming year, it will be essential for financial institutions to employ a systematic and comprehensive approach to developing a sustainable compliance program in order to better manage both known and emerging regulatory and legal risks and proactively respond to prospective market structure reforms.

8 Reforming Regulatory Reporting

The financial services industry continues to face challenges around producing core regulatory reports and other requested financial information, as demands from both regulators and investors have increased exponentially in the wake of the financial crisis. Complementing the work previously performed by the Financial Stability Oversight Council (FSOC), which solicited comment on certain aspects of the asset management industry that included requests for additional financial information that would be helpful to regulators and market participants, the SEC has proposed rules to modernize and improve the information reported and disclosed by registered investment companies and investment advisers. Among other areas of reform, the proposed release is intended to provide enhanced information that will be used to monitor risks in the asset management industry as a whole and increase the transparency of individual fund portfolios, investment practices, and investment advisers, particularly for derivatives, securities lending, and counterparty exposures. If adopted as outlined, fund administrators and managers will likely need to carefully contemplate and implement new governance, operational, and reporting capabilities that will be necessary to support these enhanced reporting and disclosure requirements.

9 Examining the Interplay between Capital and Liquidity

Recovery and Resolution Planning (RRP) and the Enhanced Prudential Standards for large U.S. bank holding companies, foreign banking organizations, and insurance and other nonbank financial companies, in particular, have brought capital planning and liquidity risk management to the forefront, as regulators have sought to restore both public and investor confidence in the aftermath of the financial crisis. Financial institutions are required to demonstrate their ability to develop internal stress testing scenarios that properly reflect and aggregate the full range of their business activities and exposures, as well as the effectiveness of their governance and internal control processes. The largest financial institutions must also provide information that will allow regulators to perform sensitivity analyses on their ability to manage their funding sources, signaling a step up in the scrutiny of financial institutions' liquidity management and how they would fare under systemwide financial stress. The latest effort to formalize the link between capital and liquidity management has come in the recently released U.S. proposal for the total loss-absorbing capacity (TLAC) held by global systemically important bank holding companies (GSIBs). If adopted in the United States as currently outlined, TLAC will be the latest, but certainly not the only, measure in the post-crisis regulatory response that connects capital and liquidity management. Other examples of this include the Basel III capital and liquidity minimum standards, namely the Net Stable Funding Ratio and the GSIB Capital Surcharge, as both discourage short-term wholesale funding. An international Insurance Capital Standard (ICS) is currently being developed that will apply to all Internationally Active Insurance Groups (IAIGs) along with a U.S. Group Calculation, though additional work still needs to be done to arrive at a common approach in the United States. The potential variability and current uncertainty resulting from these and other pending requirements, such as those related to SCCLs and early remediation, may limit funding flexibility and make capital planning difficult, as both financial institutions and insurance companies will need to consider the ties between capital and liquidity in areas such as enterprise-wide governance, risk identification processes, related stress testing scenarios, and interrelated contingency planning efforts.

10 Managing the Complexities of Cross-Border Regulatory Change

The largest financial institutions must now understand and manage regulatory mandates across more jurisdictions and services than ever before. Regulatory obligations and cross-border pressure points, including monitoring compliance on the banking side with Regulation W (transactions between insured depository institutions and their affiliates) as well as BSA/AML (Bank Secrecy Act/Anti-Money Laundering) and other financial crime requirements, continue to challenge global institutions to move past their current reactionary mode of response to tackling high-impact regulatory change. Insurers are similarly challenged with multijurisdictional reporting for groups operating cross-border. To address these challenges, financial institutions will need to consider implementing a change management framework that is capable of centralizing and synthesizing current and future regulatory demands and incorporates both internally developed and externally provided governance, risk management, and compliance (GRC) regulatory change tools. This framework will enable institutions to improve coordination across their operating silos and gain new insights that can improve overall performance, ensure risk management frameworks and compliance controls are integrated into strategic objectives, avoid redundancy and rework, and better address regulatory expectations in a practical and efficient way. Proactively addressing regulatory change is also foundational to developing an effective compliance program, as it links compliance controls with obligations, policies and procedures, monitoring, testing, reporting, and ongoing risk assessments.

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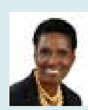

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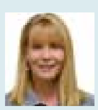

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