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Regulatory Outlook

Key areas on the horizon for banks

Produced by the Deloitte
Center for Banking Solutions

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Executive summary

There is no doubt that the rules of banking have changed dramatically over the past two decades. Many of these rules are important and needed. They help protect consumers, assure safe and sound banks, keep the financial system solvent and contribute to a strong economy. However, as banking and finance activities have become more complex, so have the rules of the road. It is not unusual to find financial institutions today that are spending two to three times as much on compliance as they were 10 or 20 years ago. In response, many bankers have observed that the regulatory compliance task has become exceedingly challenging and the cost of compliance is growing at a rate that is unsustainable.

The Deloitte Center for Banking Solutions has been examining the broad range of regulations currently facing bankers and identified six areas where closer attention is warranted. These areas of focus include:

- Enterprise-wide risk management
- Anti-money laundering
- Regulatory capital reform
- Consumer protection, predatory lending and information security
- Recent supervisory policies and guidance
- Financial stability

A solid effort in these key areas could pay off in terms of improved compliance, more reliable risk management, better service to customers and even a competitive advantage over those banking organizations that are not placing proper emphasis on compliance.



Enterprise-wide risk management

Deloitte & Touche LLP's *Global Risk Management Survey: Fifth Edition* of 130 global financial institutions found that only about one-third of institutions have an enterprise risk management (ERM) program in place. Given the number and variety of risks confronting financial institutions today, this could be a huge strategic mistake. Banks must contend with the traditional financial risks — credit, market and liquidity — as well as those dealing with operational, business continuity/IT security and regulatory compliance risk. Improper compliance especially can bring large financial penalties, as well as an increase in reputational risk for an organization. Mergers and acquisitions increase the complexity of risk management due to the need to integrate differing technology systems and risk management practices. And there are many other potential risks in such areas as alternative investments, complex innovative financial instruments and credit derivatives, energy markets, expansion in emerging markets, geopolitical concerns, natural disasters and possible pandemics.

Given the range of these potential risks, every bank should already have in place, or immediately begin to implement or upgrade, an enterprise-wide risk management program. The content and sophistication of the program will vary with the complexity and size of the organization, but an effective approach to risk management is critical for every institution.

Federal and state regulators have been encouraging bankers to implement an ERM program. Yet our survey found a lack of progress on this front. Some bankers told us that ERM is too costly to implement. Others aren't sure of the returns. And some are worried that the investment in time and resources cannot be sustained over the long haul.

Yet a successful ERM program, implemented thoughtfully and funded and staffed properly, is critically important for managing the substantial risks every bank faces. In the fifth edition of our *Global Risk Management Survey*, three out of four executives from companies with ERM initiatives told us that the total value of their programs exceeded the costs of implementing them. In terms of value, executives most often cited "improved understanding of risk," "improved regulator perception," "reduction in losses due to risk events," "improvements in rating agency perception," "earnings quality and reputation" and "transparency for shareholders."

Institutions that are doing a good job in this area tend to manage all of their risks in a holistic fashion. They possess an integrated view of the range of risks they face, and better understand the balance of risks and rewards as they formulate strategy and pursue new opportunities. More important, they are in a favorable position to use risk taking, coupled with an effective risk management program, to strengthen their competitive position and create value. A good ERM program enhances performance and profitability, targets and prevents the loss of resources, ensures effective reporting and compliance with laws and regulations and helps avoid damage to the firm's reputation.

No one size or template fits all when it comes to implementing an ERM program, but certain important principles apply to any ERM framework. To be effective, an ERM program must have the support of top-level management and the board of directors. It must be truly enterprise-wide. A good ERM program must be adequately funded and staffed by highly qualified people who are independent of the business lines and have the clout to make and influence decisions. Such a program can be the single most important step a bank can take today to ensure its survival and viability, and every bank should ask itself whether it has taken this critically important step.

Anti-money laundering

A high-quality ERM program can be especially helpful in the compliance area, and one of the most critical areas of compliance for a bank today remains dealing with the Bank Secrecy Act and anti-money laundering (AML) regulations. This is an area where banks will be especially well served by taking an enterprise-wide, global approach.

A few optimists have predicted that we're approaching the finish line for anti-money laundering regulations. The short response is: "Not yet, and perhaps never." While many banks have made considerable progress in strengthening their BSA/AML compliance programs, public policy expectations and requirements, regulatory examinations and enforcement activities will almost certainly continue to evolve. The launderers themselves are not standing still. As these perpetrators, and all who would misuse our banking system, learn new ways to circumvent the rules, bankers and law enforcement professionals will have to learn new ways to stop, and apprehend, them.

Earlier this year the Deloitte Center for Banking Solutions published *Global Banking Industry Outlook: Issues on the Horizon 2007*. A key component of the analysis dealt with anti-money laundering regulations around the globe, which have been growing in number and complexity. Regulatory guidelines and rules are not always consistent country to country or region to region. Therefore, banks have to develop integrated but flexible policies and approaches that can be adapted and applied to many countries and

markets. Unfortunately, many banks have been slow in developing such an institution-wide approach, especially those that operate affiliated financial industry services and lines of businesses such as brokerage, insurance and investment management. Many international financial institutions have yet to make their due diligence processes more transparent and less of a burden to global customers. The goal should be to minimize the need for customers to undergo a different application process with the same bank in every country.

Given that AML enforcement actions continue to be issued, it would appear that there are some basic and evolving issues banks still need to address. These include policies; procedures and internal controls; independent testing; AML organizational structure from resources and reporting lines to board and senior management oversight; internal training; service provider relationships; and self assessments; not to mention how all of these tie into an overall risk management system. Continuing to make progress in these areas is a big job and one that will require management commitment and determination in the year ahead.



Regulatory capital reform

For nearly two decades the world's largest banks have lived under the capital requirements of the 1988 Basel Capital Accord. But as financial products have become more complex, and risks more diverse, banking regulators have had to return to the topic of capital. Thus, the era of Basel II and, for less complex banks in the U.S., Basel IA has been ushered in.

We can never eliminate risk in the banking business. In fact, risk taking and its effective management and pricing are what drive the banking business and add value to our economy. But we must absolutely understand the nature and scope of the risks bankers take, and build systems that help manage those risks. With Basel II and Basel IA, it's critical that bankers know precisely what they're doing.

It's now apparent that not all U.S. institutions began preparing early enough for the Basel II transition. An informal Deloitte & Touche USA LLP online survey conducted last year asked companies to describe their Basel II implementation effort over the next 12-to-18 months. Most said they would make either a "significant" effort, with a large number of dedicated resources (41% said this), or a "moderate" effort, characterized by some level of dedicated resources (30% said this). Twenty-nine percent described their implementation effort as "low," with minimal resources. These findings suggest that some institutions may have underestimated the effort required to implement Basel II and were planning to catch up this year.

Some banks, on the other hand, are doing a really excellent job preparing for Basel II implementation. They have tended to increase collaboration among their finance, risk and technology lines of business. They have defined roles, responsibilities and accountability. They have planned for expected changes to their business processes, centralized their Basel II program management functions and taken a holistic approach to their Basel initiatives.

Basel II drives significant investments in technology and data infrastructure, but many institutions are in danger of not giving this area proper focus. The informal Deloitte & Touche USA LLP online survey found that just 20% of the companies surveyed rated their own risk data quality as "excellent," with high levels of consistency and integrity across sources, systems, operations and applications. Most (59%) described their risk data as just of "moderate" quality, while 21% rated it "challenging."

What makes all of this an even bigger challenge is that federal regulations and implementing supervisory guidelines have not yet been finalized for U.S. banks. Moreover, some aspects of the Basel II proposals themselves are ambiguous. A February 2007 U.S. Government Accountability Office (GAO) report concluded that because banks and regulators are preparing for Basel II without the final rule, "uncertainty about final requirements has made it difficult for [banks] to proceed further." GAO saw further delay as representing a potential competitive disadvantage for U.S. banks compared with foreign banks. GAO also said: "The banking regulators have differing regulatory perspectives, which has made reaching consensus on the proposed rule difficult."

Numerous complex issues remain to be resolved before final Basel II and IA rules are in place in the U.S. Many of these issues derive from the fact that the U.S. Basel II proposal requires the so-called "core or mandatory" Basel II banks to utilize only the advanced approaches to credit and operational risk with certain U.S.-stipulated prudential safeguards. The U.S. proposes a year delay in the implementation schedule, with a longer transition period, higher transition floors, and a number of prudential safeguards to prevent a significant decline in capital. In this and certain other respects, the U.S. proposal differs from the International Basel II framework. Key open issues in the U.S. include understanding the impact of the framework on individual bank capital, aggregate industry capital, and the variability of capital levels over the business cycle; reconciling the prudential safeguards with the overall objective

of greater risk sensitivity; ensuring that the capital framework continues to encourage improved risk management, while eschewing excessive complexity, cost and prescriptiveness; avoiding undue competitive distortions domestically between large and small banks; and ensuring that U.S. banking organizations are not put at a competitive disadvantage vis-à-vis foreign institutions, which are already proceeding to implement Basel II.

U.S. banking organizations have urged U.S. regulators to permit the use of the more simplified and less costly standardized Basel II option in the U.S., something that is consistent with the International Basel II framework, but heretofore not proposed for mandatory Basel II banks in this country. U.S. regulators have engaged in an extensive dialogue with the banking industry over a number of years and will, no doubt, continue to give serious consideration to the views and comments of the industry, Congress, and the public at large as they work to complete an implementable set of rules. No regulatory framework can ever be perfect, and Basel II is no exception. Nevertheless, a good deal of progress has been made, and a way forward will have to be formulated in the U.S. that assures both the safety and soundness and competitiveness of the U.S. banking system, while providing continued incentives to improve risk management — all critically important in a global financial system characterized by dramatic change and rapid innovation.

Whether a final rule will be developed in time — and whether all the core or mandatory banks will be ready at the end of 2007 to begin the year-

long Basel I-Basel II parallel processing required of them — are unanswered questions. Certainly some ambitious timelines will have to be met if the present proposed U.S. schedule is to be adhered to, and this uncertainty will make it extremely challenging for institutions to be ready in time to meet the current U.S. implementation schedule. Nonetheless, regardless of the specific details and timing of the new capital framework, the broad directions of strengthened and more sophisticated risk management and measurement are becoming clear. Best practices in risk management will continue to evolve, and whatever the precise content of the final Basel II framework, during the transition period and going forward, the framework will have to be monitored, assessed and, when necessary, refined in a way that ensures consistency with emerging sound practice, safety and soundness considerations, and domestic and global competitive and marketplace realities. Too much is at stake — both domestically and internationally — not to get this important prudential and risk management initiative right.

In this context, all banks whose regulatory capital will be affected by the prospective changes should be working to position themselves to accommodate and implement the changes. Much work has already been done, and much remains to be accomplished by both regulators and bankers. Even non-core banks will want to consider upgrading their risk management practices to strengthen their resilience, incorporate more effective methodologies and stay competitive. This is another area that cries out for a comprehensive, institution-wide risk management approach.



Consumer protection, predatory lending and information security

Most banks have long understood and been guided by the principle that treating customers fairly and complying with consumer protection statutes is both the right thing to do and good business. Even before the Democrats assumed leadership in Congress in January 2007, it was clear that their legislative focus would be on predatory lending, privacy and data security, credit card practices, affordable housing, credit access and similar consumer issues. Already some of these issues have been the subjects of Congressional hearings, and sub-prime mortgage – fueled by rising mortgage defaults – has especially gained the focus of Congressional leaders. Expect increased attention to banks' mortgage disclosures and loan underwriting practices. Other industry practices in the credit-card arena, such as "universal default" and so-called "double billing" for interest calculations, have come under fire. Several large credit card issuers have voluntarily agreed to cease these practices.

It is unclear how much time Congress will have to work on financial services legislation this year, or even in 2008. Campaigning for the elections is already well underway. Nevertheless, we expect to see increased action on the regulatory front as federal banking regulators address high-profile compliance issues and respond to Congressional interest and public concerns. Expect to see plenty of regulatory activity in a number of key consumer areas, especially in mortgage lending and disclosures.

Bankers should be taking steps now to review their lending policies and disclosure practices to identify and resolve any areas of customer frustration. One reliable benchmark would be to ask how your institution would feel if their policies and practices were described on the front page of the *New York Times*. We recommend that bankers enhance communications with their customers, step up risk monitoring and reporting, make sure consumers understand the risks in non-traditional mortgage products, strengthen underwriting standards, risk monitoring and disclosures and thoroughly analyze their Home Mortgage Disclosure Act data.

A proactive strategy can demonstrate that an institution cares about its customers and their financial welfare. If every bank undertook policies and practices like these, the industry would face much better odds of avoiding onerous new laws and costly regulations coming out of a consumer-focused Capitol Hill.

Recent supervisory policies and guidance

Bankers would certainly be wise to closely track new policies and guidance coming out of the U.S. bank regulatory agencies. In the year ahead, we recommend that bankers pay special attention to new guidance issued over the last year on nontraditional mortgage products, commercial real estate concentrations, complex structured financial transactions, allowance for loan and lease losses, and the proposal on subprime mortgage lending. As already noted, some of these areas have received increased scrutiny in the media and on Capitol Hill in recent months. It is only a matter of time before the federal regulators begin to act on what many

perceive as problem areas. Moreover, further changes are in the works. For example, the Federal Reserve has begun a comprehensive review of Regulation Z implementing the Truth in Lending Act. It is currently examining credit card disclosures and, in the next phase of the review, plans to address mortgage cost disclosures. The Federal Reserve is also holding public hearings to consider how it might use its authority to write additional rules — affecting banks and non-banks alike — addressing abusive lending practices in the home mortgage market, including the subprime sector.



Financial stability

Finally, there is the question of how financial institutions should monitor and manage their major risks and businesses to be prepared to withstand possible financial shocks or disturbances that could have broader systemic implications. Over the last several years, banks have enjoyed a very good financial and economic environment. Almost too good, some would say. The absence of significant financial adversity may have lulled a few of us into assuming that good times are inevitable. Such a view envisions continued low volatility, favorable pricing of risk, ever-rising corporate earnings, ongoing strong demand for financial products, and continued benign financial markets.

On the other hand, those who have been through a few business cycles and financial crises know that keeping the financial system solvent requires robust risk management in bad times as well as good. We know bad times don't last forever, and we should know that good times don't either. As Ben Franklin put it: "By failing to prepare, you are preparing to fail."

This is not a prediction that a particular event will trigger a financial crisis. After all, if we could predict such an event, we wouldn't let it happen. There are a number of possible triggering events: derivatives, hedge funds, oil prices, stock market drops, quickly rising interest rates, problems in emerging markets, the consequences of fiscal or trade imbalances, liquidity challenges, a housing crisis, and on and on. Whatever it is, banks should be ready.

Banking organizations, especially those engaged in national and global markets, should stress test their portfolios and exposures, not only on a business line basis, but also to understand the effect of a significant adverse development on the condition and resilience of the overall firm — including its

credit, market, operational and liquidity risks, and how these risks would be correlated under stressful conditions. Current stress testing, investment and risk-taking patterns ought to take into account a wide range of economic and business scenarios, including possible severe shocks and financial disturbances. Banks should be pricing risk effectively, implementing sound collateral and risk mitigation policies and have sound risk-management practices in place throughout the organization. The industry should also work collectively and with the public sector to ensure that payment, clearing and settlement infrastructures are robust. This isn't cautious banking; it's smart banking and reflects a recognition that both the industry and the public interest are well-served when individual banks are sound and responsive to customer needs and when the system overall is resilient and able to withstand financial adversity.

Regulation isn't going away. We expect there will be periods ahead of even more regulation, balanced most likely by periods of regulatory reform. The best performing banks will structure their risk management and compliance activities in a way that gives them a competitive advantage in both environments - and that enables them to thrive in a wide range of economic and financial scenarios.

There will be more to focus on, of course, but this list is a good starting point. In the months ahead the Deloitte Center for Banking Solutions and Deloitte & Touche LLP's publication, *@ Regulatory*, will focus in more detail on these and other key areas deserving of bankers' increased attention.

Author

Richard Spillenkothen

Director, National Banking & Finance Regulatory
Consulting Leader
Deloitte & Touche LLP
+1 202 220 2747
rspillenkothen@deloitte.com

Contributors

Irena Gecas-McCarthy

Principal
Deloitte & Touche LLP
+1 212 436 5316
igecasmccarthy@deloitte.com

Paul Kurgan

Director
Deloitte & Touche LLP
+1 202 626 4420
pkurgan@deloitte.com

Industry Leadership

Jim Reichbach

Principal
National Banking & Finance Industry Group Leader
Deloitte Consulting LLP
+ 1 212 436 5730
jreichbach@deloitte.com

Jack Ribeiro

Partner
Global Financial Services Industry Group Leader
Deloitte & Touche LLP
+1 212 436 573
jribeiro@deloitte.com

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The Deloitte Center for Banking Solutions provides insight and strategies to solve complex issues that affect the competitiveness of banks operating in the United States. These issues are often not resolved in day-to-day commercial transactions. They require multi-dimensional solutions from a combination of business disciplines to provide actionable strategies that will dramatically alter business performance. The Center focuses on three core themes: public policy, operational excellence, and growth.

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Contacts

Don Ogilvie

Independent Chairman
Deloitte Center for Banking Solutions
dogilvie@deloitte.com

Laura Breslaw

Executive Director
Deloitte Center for Banking Solutions
+1 212 436 5024
lbreslaw@deloitte.com

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