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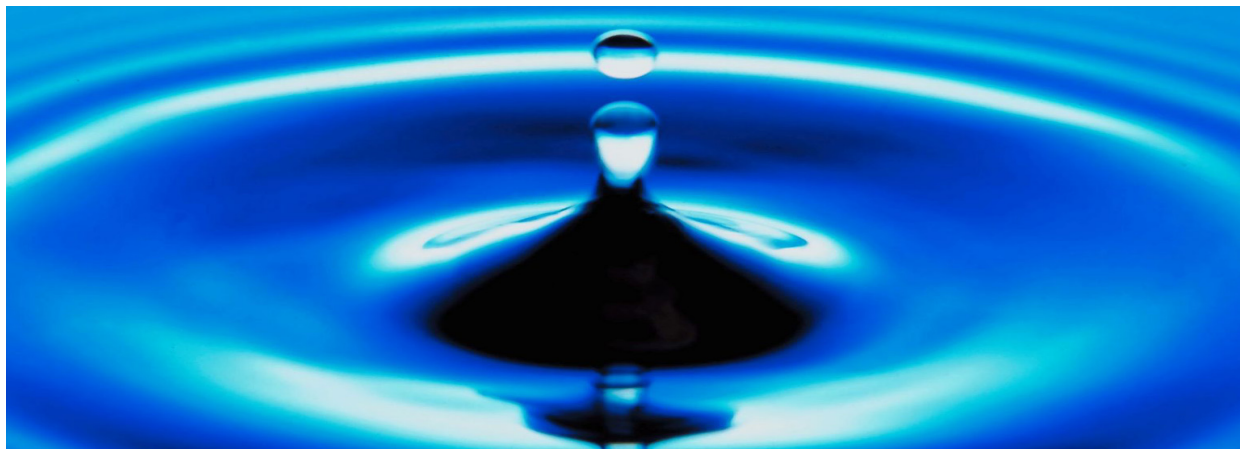
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News Bulletins: Banking

OTS Releases Revised *Examination Handbook Sections on Liquidity Risk Management and Investment Securities*

The Office of Thrift Supervision/Treasury (OTS) released, in January 2010, revised *Examination Handbook Sections 530*, "Liquidity Risk Management" and *540*, "Investment Securities." The OTS bulletin, *Regulatory Bulletin (RB) RB 37-51*, replaces *RB 32-32*, "Liquidity Management" dated December 9, 2003; and *Thrift Bulletin (TB) TB 77*, "Sound Practices for Liquidity Management," dated June 19, 2001. The revised bulletin includes new information on stress testing, contingency planning, downgraded securities, recent changes in FASB's guidance on fair value, classification guidance, and information on models in Section 540. Further, the OTS updated and revised the examination procedures accompanying each handbook Section, and added one new Appendix to Section 540: "Appendix C, Glossary of Investment Terms."¹

Liquidity Risk Management – Section 530

The OTS in Section 530, details its expectations for Liquidity Risk Management: "Associations must maintain and follow sound liquidity risk management plans, policies, procedures, and practices to ensure their ability to fund all arising financial obligations and

commitments in a timely manner."² Additionally, the OTS suggests that liquidity risk management should be robust with analysis and metrics that project a thrift's liquidity position and allow for evaluation of a thrift's options under various market conditions, such as in times of economic stress, crisis and collapse.³ In Section 530, the OTS details sound practices for managing liquidity risk, to ensure that thrifts' funding sources are diverse, and management can maintain access to different funding sources, flexibility, relationships with various funding sources, anticipated funding needs, economic/market forecasting and more.

Topics covered by Section 530 include:⁴

- Sources of liquidity risk (e.g., market liquidity risk, funding liquidity risk)
- Factors to consider in developing contingency funding plans (e.g., ratings downgrade)
- 2008 market events
- Event probability matrix
- Liquidity management (i.e., board oversight, policies and procedures)
- Areas of supervisory concern (e.g., pledged assets, diversification, mortgage banking)
- Early warning signals
- Measuring liquidity
- Primary sources of liquidity

Investment Securities– Section 540

Investment securities typically comprise a significant segment of a savings association's portfolio, interest-earning assets and liquid assets. In Section 540, the OTS describes its expectations regarding savings association's investment programs: "A sound investment program results from clear policies and objectives, and a sound investment process. The savings association should begin the investment process by determining its objectives for return requirements and risk tolerance. Management should have a clear understanding of how much return they expect the investment portfolio to generate and how much risk they can tolerate."⁵

Topics covered by Section 540 include:⁶

- Investment risks (including market risk and credit risk)
- Role of the investment portfolio
- Board and senior management oversight
- TB 13A Requirements (e.g., complex and exempt securities)
- Reporting and accounting for securities (e.g., fair value updates)
- Trading activity
- Proper categorization of securities
- Analyzing individual securities

The complete OTS bulletin, *RB-37-51*, can be found at <http://files.ots.treas.gov/74868.pdf>.

OTS Issues New Trust and Asset Management Handbook Section

On January 29, 2010, the Office of Thrift Supervision (OTS) expanded the *Trust and Asset Management Handbook* to provide examiners a program to examine an institution's administration of document custody agreements. A new section (Section 140) entitled "Introduction to Document Custody," has been added to the chapter on *Specialty Examinations*.⁷

The increase of mortgage-backed and asset-backed securities was the primary reason the OTS saw the need for a document custody services section. The volume of documentation and oversight requirements for administering, controlling and safeguarding the interests of both the issuers and purchasers of these securities has required many institutions to use the services of qualified, third-party service providers.

Mortgage-backed securities industry leaders, Ginnie Mae, Fannie Mae and Freddie Mac ("the Agencies"), are the primary users of document custody services. Each issuer of securities maintains certain eligibility and performance requirements for its document custodians. The Agencies have written manuals that describe the duties, responsibilities, reporting, controls and oversight required of their document custodians. These requirements and responsibilities have long been considered the industry standard. Document custodians who fail to comply with the requirements and standards established by the Agencies may jeopardize the marketability of securities supported by the loans or loan pools.

The document custody program defined by the OTS was created to determine the adequacy and effectiveness of the savings association's administration of its document custody services. More specifically, examiners will be expected to consider whether:

- Effective policies, procedures and internal controls have been established;
- Management and staff are knowledgeable;
- Actions and decisions are documented and supported; and
- Deficiencies are identified and promptly corrected.

The complete OTS manual can be viewed at www.ots.treas.gov/74869.pdf.

FinCEN'S Assessment of Suspicious Activity Reporting for the Insurance Industry

The Financial Crimes Enforcement Network (FinCEN) has recently issued Insurance Industry Suspicious Activity Reporting (SAR) - *An Assessment of the Second Year of Suspicious Activity Report Filings* (the "Review").⁸ The *Review*, which was issued in January 2010, primarily analyzed insurance filings from the first year of required reporting to identify typologies, patterns and trends. Additionally, the report provides insights related to the quality of the SAR reporting identified during the analysis. During the one-year period from May 2007 through April 2008, FinCEN concluded that SAR filings almost doubled in the second year of mandatory reporting, from 641 to 1,276 SARs. Interestingly, half of the filings, 628 reports, came from the subsidiaries of only two parent companies. Analysis also determined that most filers primarily reported on various suspicious payment methods as reason for filing the reports.

The top five states reporting based on subject location were New York, California, New Jersey, Florida and Texas. Policyholders and annuity owners continue to be the most reported subjects in the SAR filings for the insurance industry. Although most subjects were individuals, business entities, trusts and retirement plans were also reported. Of the 1,276 SARs filed, ninety-four named insurance insiders as subjects, primarily agents and brokers, while accountants and lawyers accounted for a total of 242 SARs.

FinCEN identified potential trends in illicit activity through analysis conducted of second year insurance filings. Some typologies evidenced in the narratives of the SARs appeared to be very similar to classical examples of money laundering stages of layering and integration. For example, many SARs reported subjects using multiple cash equivalents, such as money orders or cashier's checks, to make insurance policy or annuity premium payments.

Overall, the *Review* indicated that the quality of filings submitted by insurance companies continues to be satisfactory, with a few exceptions noted. Although not conclusive, FinCEN is still cautionary that the filing patterns observed during this analysis may be an indication of significantly divergent approaches to meeting SAR filing requirements.

financial institutions, and providing greater authority to existing regulatory bodies.

Frank's bill was passed by the House of Representatives on December 11, 2009. President Barack Obama commented that, the "Wall Street Reform and Consumer Protection Act," "[is] another important step closer to necessary, comprehensive financial reform that will create clear rules of the road" and will provide "consistent and systematic enforcement of those rules."¹⁰ The Bill is broad in scope and targets many factors that both contributed to and failed to detect the instability of the financial markets. Below is a brief overview of some of the primary components of the Bill.

Focus on Financial Stability and Consumer Protection

A significant portion of the Bill focuses on consumer protection and the Financial Stability Oversight Council ("the Council"). The Council is intended to protect Americans from "unfair and abusive financial products and services."¹¹ The Council would replace the absence of defined authority when it comes to imposing stricter prudential standards for financial stability on large companies.¹² This Council would include voting members from existing regulators such as: the Secretary of the Treasury, Chairman of the Board of Governors of the Federal Reserve System (the Board), Comptroller of the Currency (OCC), Director of the Office of Thrift Supervision (OTS), Chairperson of the U.S. Securities & Exchange Commission (SEC), Chairman of the Commodity Futures Trading Commission (CFTC), Chairperson of the Federal Deposit Insurance Corporation (FDIC), Director of the Federal Housing Finance Agency (FHFA), Chairman of the National Credit Union Administration (NCUA), and the Head of the Consumer Financial Protection Agency. The latter would be a new agency with the authority to monitor large financial services companies for compliance with consumer related laws and regulations.

This inter-agency oversight Council would be charged with the duties of monitoring the financial markets by identifying threats to stability, and international developments that may conflict with U.S. policies. The Council would advise Congress on financial, domestic, and international regulatory developments and design strategies to prepare for potential threats to economic stability. These duties are intended to prevent unforeseen failures in the financial markets.

Feature Articles: Banking

The Wall Street Reform and Consumer Protection Act: Increased Supervision, Responsibility, and Accountability

U.S. Representative Barney Frank (D-MA) introduced "The Wall Street Reform and Consumer Protection Act" (HR 4173) ("Bill") to the U.S. House of Representatives on December 2, 2009. The Bill, according to Congressman Frank, will deal with, "the catastrophe inflicted on this country by a lack of sensible financial regulation."⁹ The Bill addresses several factors that the Bill's sponsors believe contributed to the financial crisis. Many of its provisions would strengthen consumer protection. The Consumer Protection Act of 2009 takes a broad approach to combat weaknesses identified as playing a role in the United States economy a year ago. The Bill calls for establishing new regulatory agencies and financial stability committees, further regulation of



More importantly, the Bill acknowledged and granted to the Board the authority to prescribe a limit on the amount of short-term debt held by financial institutions.

An interesting component of the Bill is the granting of power to the Board to resolve and close large failing financial institutions in an orderly manner without the need of taxpayer bailouts. Furthermore, the Bill states a study is to be carried out to evaluate methods to hold financial institutions to stricter prudential standards to lessen the potential for government intervention. The study would focus on the implementation of contingent capital requirements to maximize financial stability.

Power Over Irresponsible Pay

The January 2010 issue of *@Regulatory* reported on the proposed guidance the Board has issued in regards to executive compensation packages. Executive compensation has been a widely discussed topic during the past few months. Some experts have made public their opinion that compensation structures were a contributing factor to the financial crisis.¹³ To address the issue, the Bill would give shareholders an annual “say on pay” advisory vote in regard to executive compensation. Public companies would be required to include annual nonbinding shareholder voting on executive compensation in their proxies. According to the Bill’s sponsors, this would help restore investor confidence by increasing shareholder participation, and sending a strong message to management on shareholder’s beliefs. Financial firms with at least one billion dollars in assets would need to disclose their incentive-based compensation structures.

Safeguarding Investors

There have been a number of injurious investment schemes identified during the past two years. As a means of safeguarding investors, the Bill would double the SEC’s authorized funding to obtain the necessary tools to protect these individuals. Two other aspects of the bill -- the scope of companies/ individuals that would need to register with the SEC has been expanded to include almost all advisers to private pools of capital. The SEC’s temporary Rule 10a-3T, which would require “institutional investment managers” to report to the SEC, on a daily basis, information regarding each security sold short, has been added to the Bill. Broker-dealers would need to notify investors that the option exists to prohibit their

fully paid securities from being used in connection with short sales.¹⁴ Funding for educational programs, designed to help investors understand and protect themselves against security fraud, is a new feature in the legislation. Finally, a whistleblower bounty program would be established to provide incentives for individuals who are willing to report suspicious behavior and services.

Response to Mortgage Lenders

Reflecting on the highest foreclosure rates in decades, the Bill addresses the fragmented oversight of the mortgage industry. In response to unfair lending practices, the Bill specifies new mortgage reform and an anti-predatory lending bill that strives to restore integrity to the mortgage industry. The standards outlined would include the following requirements:¹⁵

- Lender makes a "reasonable and good faith determination" that, at the time the loan is made, the consumer has a reasonable ability to repay the loan, according to its terms.
- Lenders would be directed to provide loans that benefit the consumer and steer them away from high cost mortgages that contain balloon payments and provisions.
- Regulations previously established for the primary mortgage market would apply to the secondary mortgage market to ensure that loans bought and later sold as securities receive accurate credit ratings and contain more transparency.

Reform on Credit Agencies and the Insurance Industry

SEC Chair Mary Schapiro recently pointed out that “rating agency performance in the area of mortgage-backed securities backed by residential subprime loans, and the collateralized debt obligations linked to such securities has shaken investor confidence to its core.”¹⁶ Rating agencies have recently faced litigation regarding ratings of their mortgage-backed securities and the conflict of interest that may arise when the fee for the rating agency is paid by the issuer of the debt instead of the investor who is relying on the rating. The Bill would require each nationally recognized statistical rating organization to publicly disclose information on initial ratings and subsequent changes to such ratings as well as allowing investors to compare performance of ratings by different nationally recognized statistical rating organization. This is designed to help reduce market reliance on these entities,

reduce conflict of interest, as well as impose a liability standard on the agencies.

In addition to new standards for credit agencies, the Bill addresses the need for a federal agency to monitor the insurance industry. A Federal Insurance Office would be created with the following duties:

- Monitor the insurance industry
- Identify issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry
- Monitor traditionally underserved communities and consumers, minorities, and low and moderate income persons have access to affordable insurance products regarding all lines of insurance, except health insurance.

Summary

The Bill has been sent to the U.S. Senate and referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The Bill proposes significant changes for all participants in the financial services industry. While final legislation may be many months in the future, the Bill's provisions in the meantime will receive considerable and discussion from interested parties.

For additional information on this topic, contact Paul Kurgan, director, Deloitte & Touche LLP, pkurgan@deloitte.com, +1 202 626 4420.

Feature Articles: Insurance

Federal Insurance Office Act Passed by U.S. House Financial Services Committee

On December 2, 2009, the U.S. House Financial Services Committee passed the Federal Insurance Office Act (H.R. 2609) introduced by Representative Paul Kanjorski (D-PA), a member of the committee, in May 2009. The legislation, if passed, would create a Federal Insurance Office (FIO), which would be established under the U.S. Department of the Treasury ("the Treasury"). Chaired by Representative Barney Frank (D-MA), the Committee's approval of the FIO Act signals a victory for Frank's broader reform package, which has recently focused on his Financial Stability Improvement Act.

The bill was originally introduced as the Insurance

Information Act and although it has gone through several iterations since its original introduction, the key objectives of the legislation remain intact. The intention of the bill is to develop an entity at the federal level with deep, thorough insurance knowledge and expertise to advise the government on the insurance industry. In response to recent economic events that have transpired in the United States in the last 18 months, the FIO would be established with the aim of providing information and resources to national insurance lawmakers. Its authority covers all insurance lines except health. In responding to the passage of the bill he introduced months earlier, Congressman Kanjorski said, "I have been working on this bipartisan bill since 2008, and I am pleased that the new administration recognizes the importance of ensuring that the federal government has a knowledge base on insurance. With the improvements made to the bill today through amendments, we can now continue to move this important bill and the other regulatory reform bills through the legislative process. I am eager to pass these bills in the House."¹⁷

The FIO would be led by a Director appointed by the Secretary of the Treasury. Some of the key responsibilities of the FIO would be to collect and analyze industry information, coordinate federal policy and efforts on prudential aspects of international insurance matters, participate in the International Association of Insurance Supervisors, consult with states as appropriate, provide advice to the Treasury on major and prudential international insurance policy issues, ensure that state insurance laws remain consistent with federal policy on international trade agreements, and provide a report to Congress on an annual basis describing actions taken by the new office. The FIO would not, however, have subpoena power and it would not have general supervisory or regulatory authority over the business of insurance. Additionally, the FIO Act would take measures to assess current insurance regulations and work to mitigate risks that are inherent within the national insurance system. Should it be determined by the FIO that certain insurers are at significant risk, the FIO would have the authority to recommend greater scrutiny regarding these entities to a new systemic risk regulator.

Although the House Financial Services Committee passed the FIO Act by a unanimous voice vote in committee during its December 2009 session, the legislation is not without its opponents within the insurance industry. In particular, the FIO Act's focus on determining whether state insurance measures are inconsistent with state regulators' policies has



some fearing that a federal regulatory body would limit states' abilities to regulate insurance. The National Association of Professional Insurance Agents (PIA) is one group that has voiced such concerns. National Executive Vice President and CEO Leonard C. Brevik explained after the Committee's passage of the FIO Act, "Creation of an FIO greatly increases the possibility that this office will be used by advocates of federal insurance regulation to advance their goals. In fact, this bill was amended during the committee mark-up by advocates of optional federal charters to require that the newly-created FIO conduct a study of federal insurance regulation. This would put the FIO itself in the position of recommending to Congress whether the power to regulate insurance should be taken from the states and its own authority expanded. PIA continues to work with House members to ensure that any assigned study on insurance regulation is done in a non-partisan, unbiased way."¹⁸

The FIO Act identifies the office's role as a liaison between the federal government and the individual states, which has encouraged others who believe that a federal body should be empowered to govern the insurance regulatory landscape. In a statement released by the American Insurance Association (AIA), President and CEO Leigh Anne Pusey stated, "The current state-based insurance regulatory system is not well-suited to bridge information or regulatory gaps that may arise in today's complex and global economy. Creation of a Federal Insurance Office will help prevent future financial crises from occurring and will identify potential regulatory gaps that exist in the current financial regulatory structure."¹⁹ The AIA represents approximately 350 insurance companies that provide all lines of property and casualty insurance.

FI would be responsible for reporting annually to the U.S. Congress on matters such as the overall financial state of the insurance industry as well as arising trends developing within it. Furthermore, an advisory group, described within the legislation, would report directly to the Treasury Secretary and the FIO Director, making recommendations regarding the functions of the Federal Insurance Office itself. This Advisory Group would be comprised of 13 members including state insurance commissioners, state legislators, and representatives of the insurance industry. Advisory group members would be appointed by the Secretary of the Treasury.

Similar legislation has been sponsored by Senator Chris Dodd (D-CT) as part of his bill titled, "Restoring American Financial Stability," which calls for the creation of an Office of National Insurance to monitor the insurance industry and identify gaps in regulation. Unlike the FIO Act, Senator Dodd's legislation grants the proposed federal office subpoena power, which was removed from the House bill sponsored by Representative Kanjorski.

For additional information on this topic, contact Tim Ackerly, senior manager, Deloitte & Touche LLP, tackerly@deloitte.com, +1 312 486 4209.

Contributors



The Editors would like to thank the following contributors from Deloitte & Touche LLP to the News Bulletins:

Michele Kaiser (Banking), Kathi O'Brien (Banking), Richard Rosenthal (Banking)

Additional Contributor to the Banking Feature

Article: Stephanie Vo (*The Wall Street Reform and Consumer Protection Act: Increased Supervision, Responsibility, and Accountability*)

Additional Contributor to the Insurance Feature

Article: Michael Ruiz (*Federal Insurance Office Act Passed by U.S. House Financial Services Committee*)

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End Notes

¹ <http://files.ots.treas.gov/74868.pdf>

² Ibid., 2.

³ Ibid., 2.

⁴ Ibid., 1-48

⁵ Ibid., 49

⁶ Ibid., 48-177

⁷ <http://files.ots.treas.gov/74869.pdf>

⁸ http://www.fincen.gov/news_room/rp/files/Insurance_update_pub.pdf

⁹ <http://thehill.com/opinion/editorials/72413-barney-franks-bill>

¹⁰ <http://my.barackobama.com/page/community/post/CloeAxelson/gGMyRp>

¹¹ http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/CFPA_Summary_of_HR_3126.pdf

¹² http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/4173summary120809.pdf

¹³ http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/4173highlightsFINAL.pdf

¹⁴ http://www.martindale.com/members/Article_Atachment.aspx?od=101644&id=880598&filename=asr-880638.Actof2009.pdf

¹⁵ http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf

¹⁶ <http://www.compliancebuilding.com/2009/04/23/credit-rating-agency-reform/>

¹⁷ http://kanjorski.house.gov/index.php?option=com_content&task=view&id=1675&Itemid=114

¹⁸ <http://www.prnewswire.com/news-releases/pia-says-concerns-remain-with-federal-insurance-office-act-78466582.html>

¹⁹ <http://www.aiadc.org/aiadotnet/docHandler.aspx?DocID=329659>

Managing Editor:

John Graetz
Principal
Deloitte & Touche LLP
jgraetz@deloitte.com
+1 415 783 4242

Sector Editors:

Jeanne-marie Smith
Manager
Deloitte & Touche LLP
jeasmith@deloitte.com
+1 202 879 5611

Karen Vaughn
Senior Manager
Deloitte & Touche LLP
kvaughn@deloitte.com
+1 703 251 1388

Nicholas Denton-Clark
Senior Manager
Deloitte & Touche LLP
Ndenton-clark@deloitte.com
+1 212 436 4090

Moshe Sinensky
Senior Manager
Deloitte & Touche LLP
msinensky@deloitte.com
+1 212 436 5421

Editorial Manager:

Jeanne-marie Smith
Manager
Deloitte & Touche LLP
jeasmith@deloitte.com
+1 202 879 5611

Financial Services:

Henry Ristuccia
Partner
Deloitte & Touche LLP
hristuccia@deloitte.com
+1 212 436 4244

Rhoda Woo
Director,
Deloitte & Touche LLP
rwoo@deloitte.com
+1 212 436 3388

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