



# Preparing for Regulatory Reform

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*U.S. financial markets may not know for some time what shape regulatory reform will take, but regulatory change, structural or otherwise, is under way.*



U.S. financial markets have been under siege for more than a year, and legislators, regulators, and the public urgently want solutions. From proposals to strengthen consumer protection to heightened regulatory examinations of risk governance, credit and liquidity risk management, capital adequacy, and even the entire overhaul of the regulatory system, the financial services industry is feeling the pressure.

Historically, significant market events have been followed by wide-ranging and demanding regulatory changes (e.g. Gramm-Leach-Bliley and Sarbanes-Oxley Acts), supporting the inevitably reactive rather than proactive nature of financial services regulation. As global competition and pressures to meet investor expectations drive product innovation and the melding of financial services, regulation has always lagged the evolution of our financial markets.

But regulatory reform requires thoughtful consideration. Designing an enhanced

oversight structure to detect and prevent further global financial market crises takes dialogue, informed analysis, and time. The biggest challenge for financial industry executives is determining how this array of regulatory activity will affect their institutions and, as a result, anticipate the imminent changes they need to make and those they can put on a long-term plan.

In the United States, multiple regulatory bodies and lawmakers at the federal, state, and local levels along with other financial services

industry stakeholders are vigorously engaged in the reform discussion. In Europe, advanced regulatory capital frameworks introduced by both Basel II and Solvency II are progressing, and future regulatory enhancements are expected to have a significant impact on capital requirements going forward. As regulators debate where regulatory reform should be heading, the financial services industry can look to available guidance and regulatory trends to begin work to strengthen their risk controls and exercise prudent oversight.

## A History of Market Turmoil and Key Regulatory Actions

Period of Turmoil	Regulatory Agency Development	Regulatory Acts	
	Office of the Comptroller of the Currency (1863)	National Bank Act (1863)	
1907–08	Federal Reserve System (1913)	Federal Reserve Act (1913)	
1929–33	Federal Deposit Insurance Corporation (1933) Securities and Exchange Commission (1934) Financial Industry Regulatory Authority (1934)	Reconstruction Finance Corporation (1932) Glass-Steagall Act (1933) Securities Act (1933) Securities Exchange Act (1934)	Federal Credit Union Act (1934) Social Security Act (1935) Investment Company Act (1940) Investment Advisors Act (1940)
1945–47, 1953–54, 1957–58		Bank Holding Company Act (1956) Consumer Credit Protection Act (1968) Bank Secrecy Act (1970)	Fair Credit Reporting Act (1970) Investment Company Act Amendments (1970)
1974–75	Commodity Futures Trading Commission (1974)	Equal Credit Opportunity Act (1974) Commodity Futures Trading Commission (1974) Uniform Net Capital Rule (1975)	Securities Act Amendments (1975) Community Reinvestment Act (1977) Electronic Fund Transfer Act (1978) International Banking Act (1978)
1980–82, 1987, 1990–91	Office of Thrift Supervision (1989)	Monetary Control Act (1980) Insider Trading Sanctions Act (1984) Money Laundering Control Act (1986) Competitive Equality Banking Act (1987) Insider Trading & Securities Fraud Enforcement Act (1988)	Financial Institutions Reform, Recovery & Enforcement Act (1989) Resolution Trust Corporation (1989) Market Reform Act (1990) FDIC Improvement Act (1991) Riegle-Neal Act (1994)
2001, 2009	Financial Industry Regulatory Authority (2007)	USA PATRIOT Act (2001) Sarbanes-Oxley Act (2002)	

Source: KPMG Internal Research based on National Bureau of Economic Research, [www.nber.org](http://www.nber.org), and Bureau of Economic Analysis, [www.bea.gov](http://www.bea.gov).

*Changes in regulatory oversight will need to accommodate the fact that 21st century global financial markets have become irrevocably linked by counterparties and market forces that transcend the banking, securities, and insurance sectors.*



## The Issues

The events of the current economic crisis have been well documented from defaults on subprime mortgages and the collapse of the securitization market to substantial asset impairments and takeovers and bailouts of household names. With severe investment losses and frozen credit markets, recessionary forces have taken hold, unemployment has soared, and consumer confidence has plummeted. The 21st century global financial markets are irrevocably linked by counterparties and market forces that transcend the banking, securities, and insurance sectors, and lawmakers and regulators in every developed country have been hard at work on proposals they hope will improve the stability of the markets and control the excesses of the institutions that operate within them.

As regulators and lawmakers consider their next steps, they are looking at the numerous, complex causes of the financial crisis. Buyers and sellers of both real property and financial instruments had unrealistic expectations, as for example, many home-owners assumed that property values would increase indefinitely or at least remain stable. Product innovation led to an increasing prevalence of complicated products, e.g. collateralized debt obligations (CDOs) and credit default swaps (CDSs), where regulatory oversight was either minimal or nonexistent. In fact, various significant market participants, from credit rating agencies to hedge funds and other asset managers to nonbank mortgage lenders and insurance brokers, had little or no regulatory oversight. Many—at both the consumer and institutional level—were convinced that their investments were reasonably sound in light of continued robust market conditions, but the effects of resultant asset impairments have been far-reaching, compromising variable annuity guarantees and retirement plans.

Globalization allowed for presumed diversification of risk through a variety of instruments across geographies, and effective regulation was challenged by fragmented regulatory structures both within the United States and abroad. Home country regulators were limited in their abilities to address systemic risk emanating from beyond their boundaries.

Fraud, too, has a place in the mix of issues surrounding the current turmoil. Numerous alleged Ponzi schemes have been reported by the news media recently. Incentive systems seem to have led many individuals—both buyers and sellers—to behave inappropriately for their own gain. Certain mortgage lenders allowed high-risk borrowers to borrow; a number of consumers falsified information in order to borrow more money than was appropriate.

A failure to adequately recognize the frequency and severity of potential risks and to mitigate them accordingly seems to be at the heart of the crisis. A lack of effective internal risk management procedures in financial institutions certainly helped cause the economic instability and harm to consumers and investors. The focus now is on risk management, transparency, and governance, both internally—all the way up to the board level—and externally, from regulators and the market participants. Regulators will evaluate banks, insurers, and security broker-dealers to ensure that they have core risk management controls, adequate financial resources, skilled personnel, ethical conduct, governance and risk structure, clear accountabilities, and complete and cooperative supervisory compliance with the programs. These organizations will need to demonstrate respect for basic tenets of safety and soundness, financial stability, fairness, adequate and transparent disclosure, and appropriate conflict-of-interest management.

Regardless of any changes to the regulatory oversight structure, the focus will continue on how financial service companies manage their risks—including how they are perceived by consumers, investors, and the public.

It is difficult to keep up with all of the proposals for new reforms and guidelines that may be implemented, and many details have yet to be finalized. Yet several regulatory bodies have proposed overarching themes that are worthy of consideration as governments work toward their proposed solutions.

The Government Accountability Office (GAO) recently issued a report to Congress on potential enhancements to the financial regulatory system. The report highlighted multiple gaps in the current system and suggested the following nine characteristics for improvement:

1. Clearly defined regulatory goals with an appropriate balance of broad principles and specific rules.
2. Appropriately comprehensive regulations, using a risk-based approach, which provides for protection while still allowing for innovation, capital formation, and economic growth.
3. A system-wide focus in order to identify and act on systemic risk.
4. A flexible and adaptable approach for monitoring developments and identifying risks.
5. Efficient and effective oversight through elimination of overlaps, possible consolidation, and better alignment between federal and state roles.
6. Consistent consumer and investor protection.
7. A system allowing regulatory agencies to have independence, prominence, authority, and accountability.
8. Consistent financial oversight of those institutions, products, and services that pose similar risks.
9. Safeguards to prevent financial instability while minimizing moral hazard as well as taxpayer loss.

Similarly, the Congressional Oversight Panel (COP) monitoring the Treasury Department's Troubled Asset Relief Program (TARP) has presented three principles for reform

designed to balance the costs and benefits of regulation:

1. Better oversight of systemic risks without creating the moral hazard that results from implicit government guarantees for high-risk behavior.
2. Better transparency regarding risk through more accurate credit ratings.
3. Better regulation of consumer financial products, with greater fairness.

Certain regulatory elements related to financial services are beginning to take shape as President Obama and his administration seek to act swiftly to restore the economy to health. In addition to the recently enacted American Recovery and Reinvestment Act and the Financial Stability Plan announced by the Obama administration, these initiatives seem to be gaining in popularity:

- Creation of a systemic risk regulator with authority to regulate systemically important companies. This would include oversight of affiliates of financial holding companies, with the goal of preventing some of the lapses that led to the current crisis.
- Rationalization of the patchwork of regulatory agencies across financial services industries and at the state and federal levels. For example, both an Optional Federal Charter for insurers and an Office of Insurance Information to collect and analyze insurance data at the national level seem to be gaining momentum.
- Increase in regulation of investment managers either through existing regulatory agencies such as the Securities and Exchange Commission or the creation of a self-regulating body for investment advisors.

In fact, Treasury Secretary Geithner recently revealed to Congress an outline of the administration's framework for regulatory reform, which included four basic components:

- Addressing systemic risk
- Protecting consumers and investors

- Eliminating gaps in the regulatory structure
- Fostering international coordination.

Under the first of these, the framework would call for more consistent and conservative regulation of systemically important firms, including higher standards for capital and risk management, as well as the establishment of a single independent regulator with dedicated oversight responsibility.

Mr. Geithner further noted the harm that can result from weaknesses in consumer and investor protection, indicating that reform will include stronger regulations to simplify the financial decision-making process for consumers and to prevent abusive practices. It is possible that changes could include a governmental agency with authority to monitor all financial products marketed to consumers.

Similar regulatory reform proposals have been released in other countries to stem the effects of the financial crisis, which is decidedly global. One such proposal prepared in the United Kingdom, The Turner Review, looks at increased capital and liquidity requirements, stronger supervisory and regulatory oversight of derivatives markets, and more specifically, hedge funds, and regulation of cross-border entities, among many other things. The approaches vary between countries, with some looking to strong central bank involvement and changes in the supervisory and regulatory architecture, and others considering only regulatory improvements.

And again, recognizing the global nature of the financial crisis, the G20 countries have agreed to principles for an international financial architecture that address consistent regulation of systemically important entities; enhanced transparency, supervision, and regulation of derivatives; increased "cushions of stability" under capital and accounting standards and reduced pro-cyclicality; and "financial market integrity."



# Practical Issues and What Companies Can Do Now

Regulatory focus will clearly be on forward-looking risk management, stress-testing, and capital management. The full spectrum of risks—credit, market, operational, liquidity, concentration risk, and the like—and the processes in place to mitigate them will be part of the focus as seen through a regulatory lens. The need to demonstrate effective risk management is paramount.

Within the risk management framework, there are many areas where financial services firms can build on existing sound practices. For example, firms' boards and senior management can review their responsibilities and emphasize their accountability to manage organizational risks, even as they keep pace with innovation and changes in business models. They can evaluate their compensation structures against risk management awareness and practices to ensure compensation models align with long-term, firm-wide profitability (from realized gains) and their risk profile. All companies can perform in-depth analysis of the impact of risk management failures to better align capital and liquidity thresholds to support them. Such processes amount to self-identification and self-correction of control weaknesses and will reinforce sound internal controls.

While the current environment makes the timing ripe for regulatory action and the risk of enforcement actions is high, there is no need for companies to wait for regulatory intervention; senior management has the ultimate authority to promote sound risk management now. Such actions will mitigate not only regulatory risk but operational and reputational risk as well.

## **Risk Governance and Controls**

Strong risk governance contemplates an approach to risk management that allows for management of an institution's risk profile at the aggregate level, in alignment with its risk appetite and in accordance with internal and external expectations. This approach includes a clear business strategy, establishment of policies and procedures that support the strategy, delineation of roles and responsibilities, and an adequate infrastructure for supporting the business objectives. In a strong risk governance environment, there is collaboration with internal audit and compliance departments to improve control activities and reduce risk.

## *Risk Identification and Assessment*

A number of processes should exist to ensure that risks are identified, measured, and mitigated in line with the desired risk appetite and considering the company's current risk profile. Business units cannot operate in silos when evaluating risk. While aggregating risks is challenging both from a cultural perspective and a technical perspective, informed, strategic business decisions can only be made when a truly integrated picture of an entire enterprise's risk profile is available.

Financial institutions can improve risk assessment processes by:

- Conducting their own analysis of the credit and other risks of new financial products to avoid over-reliance on credit rating agencies
- Managing counterparty risk through better risk modeling relative to insurers, reinsurers, and participants in credit-default and interest-rate swaps

## *Many areas in which to take proactive action are based on existing sound practices.*

- Assessing the effectiveness of their compliance controls and risk management measures regarding OTC derivatives business
- Developing systems to provide adequate product mapping of complex financial instruments

Given the scrutiny that quantitative models have received lately, it is important that companies inventory and test their models, ensuring that they are consistent with current operations and business models. Sound practice involves independent and objective model validation as well as stress testing for reliable measurement of complex risks and their interactions. For banks and securities firms, conducting stress-testing or “shock-testing” of asset valuations is certainly a current regulatory focus to identify potential implications for liquidity and capital adequacy, while a similar focus on capital adequacy models exists for insurers. Qualitative measures should also be employed to avoid over-reliance on quantitative outputs that may be based on highly judgmental assumptions.

Another critical area involves strengthening controls around the securitization process. Measurement and internal controls over structured credit and off-balance-sheet exposures will be vital. Market participants are already working to align adequacy of regulatory capital requirements with exposures to certain complex structured credit products such as CDOs of asset-backed securities (ABSs), which also affect the credit exposure of banks and financial firms’ trading portfolios.

### *Policies and Procedures*

Regulators will monitor the progress of banks, insurers, and investment firms in their efforts to strengthen risk management and capital planning practices. Well-designed and actionable procedures for mitigating the risks that created so much recent instability will be key to restoring faith in the markets. Clear policies should set the standards for appropriate and acceptable behavior in decision making. Examples include:

- Defining and developing a monitoring mechanism for risk appetite standards
- Standardizing methodologies for the identification, management, and reporting of risks, including consideration of credit and market conditions
- Developing methodologies for addressing worst-case scenarios for the resultant risk profile in relation to the risk appetite
- Establishing procedures to ferret out conflicts of interest in business operations
- Aligning compensation and incentives policies with proper behavior and regulatory requirements
- Establishing mechanisms for adequate and consistent disclosure of risk exposures, valuations, and risk management measures.

### *Communication, Both Internal and External*

Internal communication helps facilitate “buy-in” relative to risk management and compliance policies from the participants involved in implementing business strategies. Communication enables all areas to understand how their actions interact with others. And, ultimately, clear communication regarding roles and responsibilities within the organization lays the groundwork for holding people accountable for their actions.

From a market-facing perspective, financial institutions will need to be able to describe both the risks and rewards of their products along with their level of responsibility with respect to the customer’s principal, especially for structured products—and to verify that consumers understand those products. All market participants need transparent access to information about on- and off-balance sheet exposures and capital adequacy. Accordingly, firms’ internal processes to discuss new products should be thorough, and the rating process for new products should be transparent. An effective process for escalating any discovered issues needs to:

- Evaluate the process to identify and report escalating emerging problems—and mitigate them in a timely manner
- Evaluate current overall disclosure processes to ensure they are in line with leading disclosure practices

- Elevate collaboration with regulators to improve understanding and smooth the examination process.

### *Training*

Training is an essential component to managing risk, as employees need to understand the implications of their business conduct and the risks associated with complex new products. Financial institutions will need to show that their professionals are familiar with the changing regulatory requirements and receiving all the pertinent regulatory and policy updates.

As part of a robust governance framework, training will encompass instruction on the organization's policies, procedures, and standards of conduct, with clear articulation of each employee's roles and responsibilities, reporting structure, and levels of authority. Firms should continue to focus on personnel development and consider enhancing existing mechanisms to measure the effectiveness of their policies and procedures and training programs. With such a framework, organizations lay a strong base for enabling compliance and mitigating the risk of unintentional violations.

### *Monitoring and Reporting*

A functional framework for the overall risk management process includes regular monitoring of risks and rewards, along with reporting the information upward to senior management and the Board of Directors. A mechanism should exist for determining if, for example, underwriting guidelines are not being followed or authority limits are being circumvented. Once policies and procedures are in place and thoroughly communicated, periodic testing can help determine if such procedures are effective and help ensure compliance.

Informative, regular reporting could include risk dashboards along with trigger points for action at certain predefined thresholds or incident logs flagging areas of concern that require attention. Such steps may not prevent calculated risks from performing at less than desired levels, but they allow for an early warning system where corrective actions can be taken as needed.

### *Accountability*

With policies and procedures in place and expectations communicated throughout, all within the organization—from senior management to risk owners to support staff—must be held accountable for their actions. If roles and responsibilities are clearly identified and communicated, employees should be aware of the actions and behaviors expected of them. Proper enforcement mechanisms should be developed for noncompliance. Additionally, the impact of compliance on employee compensation has been a topic of interesting debate and should continue to be considered as a potential measure to drive accountability. The expectation is that senior management and the board will become more engaged in the future, hold employees at all levels accountable, and in fact hold themselves to the same high standards as well.

While leading practice suggests that organizations have such frameworks in place already, external forces may impose such accountability as well. For example, a number of proposals are circulating in relation to accountability associated with receiving TARP funds (see related sidebar).

# Accountability and Reporting Related to the Use of TARP Funds

Recipients of TARP funds must be prepared for greater oversight and scrutiny relating to their usage of the funds. In response to concerns raised by GAO, COP, and members of Congress, the Treasury and the Office of the Special Inspector General for the TARP (SIGTARP) have recently taken measures to increase recipients' accountability for the funds received.

Treasury anticipates using quarterly call report data to study lending activities; for those institutions receiving the most significant TARP funds, Treasury will request supplemental monthly data on business and consumer loan activities as well as purchases of mortgage-backed and asset-backed securities.

SIGTARP has requested each recipient to provide the following:

1. Narrative response outlining the use or expected use of the TARP funds
2. Copies of supporting documentation relative to the narrative response
3. Description of plans for compliance with executive compensation restrictions
4. Certification by a senior executive officer as to the accuracy of all statements, representations, and supporting documentation

TARP recipients should be taking action now to:

- Clearly define all terms and data used in reporting on TARP funds
- Understand the compilation and data sources used to generate TARP reporting
- Recognize how reporting data ties to or differs from other regulatory reporting
- Transfer raw data from systems into meaningful formats for meeting the various reporting needs
- Monitor ongoing TARP activity within the regulatory agencies and Congress
- Develop internal audit procedures surrounding TARP and other associated reporting
- As appropriate, develop corrective action plans to rectify any issues in the reporting process



## Conclusion

The current financial crisis has shown that safety and soundness, solvency, consumer protection, and systemic risk are intertwined. Stable future markets necessarily will focus on financial soundness, more transparency, and consumer protection across the spectrum of consumer products—areas that, at a minimum, include real estate secured originations and servicing, guaranteed income embedded in variable annuities, and credit card lending terms and payment allocations. There will be calls for increased disclosures surrounding both risks and rewards associated with financial products to allow informed decisions by both investors and consumers. Increased supervisory oversight of the capital management process will encompass risk management measures for liquidity as well as credit, market, and concentration risks as they affect capital adequacy and solvency levels. Risk management transparency will improve for off-balance-sheet commitments, which are sensitive to organizations' credit, operational risk, and liquidity measures.

Regardless of market conditions or the ultimate changes to the regulatory oversight structure, regulatory reform—in terms of intensified scrutiny, proposals to increase regulation, and the demand for risk management controls—is already at hand. And the cost of noncompliance will only increase going forward, both in absolute terms relative to greater sanctions for violations and through potential loss of reputation. As the public debate continues, financial service providers are in a position to make proactive, positive changes to their controls in order to help exercise prudential risk oversight. The transparency inherent in strong risk management and governance can go a long way toward restoring confidence to external stakeholders—a potential for competitive advantage. The marketplace doesn't have to wait for new rules; the ability to prove to regulators, policy-makers, and the public that appropriate actions have been taken exists today.

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