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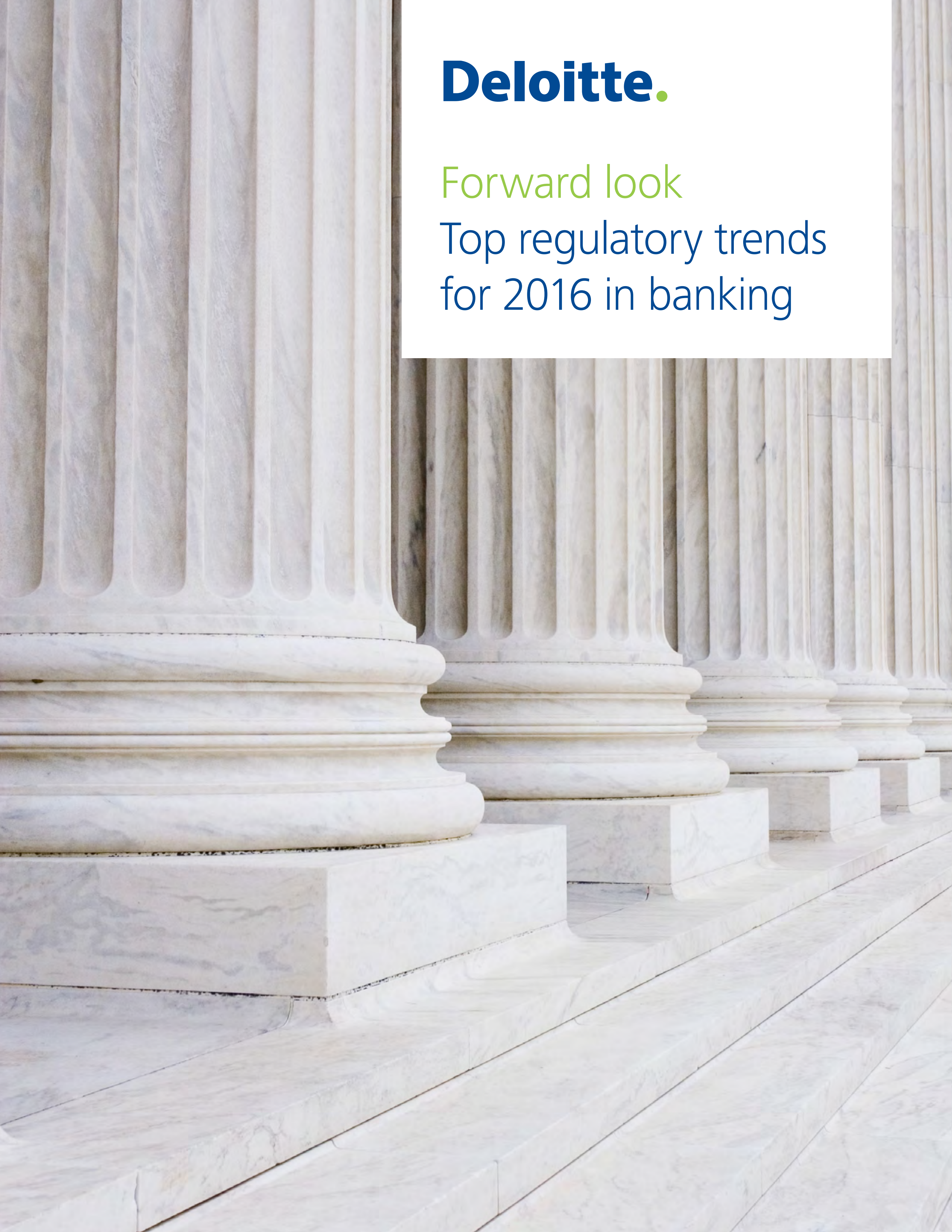
Forward look
Top regulatory trends for 2016 in banking



Foreword

This publication is part of the Deloitte Center for Regulatory Strategies' cross-industry series on the year's top regulatory trends. This annual series provides a forward look at some of the regulatory issues we anticipate will have a significant impact on the market and our clients' businesses in the year ahead. For 2016, we provide our regulatory perspectives on the following industries and sectors: Banking, Securities, Insurance, Investment Management, Energy and Resources, Life Sciences & Health Care.

The issues outlined in each of the six reports provide a starting point for the crucial dialogue about future regulatory challenges and opportunities to help executives stay ahead of evolving requirements and trends. We encourage you to share this report with senior executives at your company. Please feel free to contact us with questions and feedback at centerregstrategies@deloitte.com.

Best regards,

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Introduction

The year 2015 was focused on change. The banking industry has moved beyond reacting to Dodd-Frank regulations and is plotting a forward course through this new regulatory landscape. Major themes include transparency, interconnectedness, accountability, and strategy. How will institutions achieve their goals, meet stakeholder and regulatory expectations, and respond to the next round of regulatory changes? Managing regulatory compliance and risk has never been more complex.

Regulatory expectations continue to rise, with increased emphasis on each institution's ability to respond to the next potential crisis. Regulatory supervision, often through oversight from multiple regulators, has moved beyond the planning phase and is now focused on tools and implementation supported by strong ethics, culture, and related accountabilities at every level of the organization.

This report looks at 12 key regulatory trends in banking for 2016:

1. Governance and risk management
2. Culture and ethics
3. Capital planning and stress testing
4. Recovery and resolution planning
5. Enhanced prudential standards for foreign banking organizations
6. Consumer protection
7. Cyber threats
8. Data quality, analytics, and reporting
9. Model risk management
10. Credit quality concerns
11. New risks from financial innovation and migration of activities
12. Linking regulatory strategy to business strategy

Some trends from 2015, such as the concerns about credit quality, continue into the new year. Meanwhile, the impact of technology on every aspect of banking operations and strategy can be seen throughout the 2016 regulatory picture—from model risk management to data quality to the focus on preventing and responding to cyber threats. Using technology as a tool to enhance compliance and credit quality can both decrease and increase risk. Finding the right balance among investment, maintenance, and innovation is now an essential part of risk management and compliance.

If 2015 was focused on change, 2016 may be the year of transformation. The following pages provide practical insights and guidance for banking institutions as they prepare for the challenges ahead.

1. Governance and risk management

Many bank managers continue to face challenges in implementing a comprehensive enterprise-wide governance program that meets regulatory expectations. These expectations are outlined by the Federal Reserve Board (FRB) in its Enhanced Prudential Standards (EPS) rule, and by the Office of the Comptroller of the Currency (OCC) in its Heightened Standards (HS) formal guidelines, as well as by other sources including the FRB's Supplemental Policy Statement on Internal Audit, regulatory speeches, and direct communications with the banks.

Although it is most clearly articulated in the OCC's HS guidelines, many regulators are communicating expectations for large bank risk management frameworks that include well-defined roles and responsibilities for the three lines of defense: front-line units, independent risk management (which includes compliance), and internal audit.

In the front-line units, gaps sometimes exist between regulatory risk management expectations and bank practices. Regulators expect front-line units to own and be accountable for managing the risks in their business lines. Since the front line creates risks for banks, it needs to own and be accountable for those risks. Also, since the risk environment is constantly changing, the front line is expected to conduct ongoing risk assessments to determine if additional actions are needed to strengthen risk management practices or reduce risk. The independent risk management function shares responsibility for overseeing and assessing the firm's risks, but it should not be viewed as a substitute for robust risk management within the business lines.

For some banks, the front-line culture has traditionally been less focused on managing risk and more concerned about activities that generate revenue or reduce expenses. Finding the right balance might require a cultural shift in some organizations. (For details, see the "Culture and ethics" discussion.) Elevating the front line's role as a stakeholder in the overall governance and risk management process has a number of potential benefits. Since the front-line units have the most intimate knowledge of the business, getting them more involved in the process can enable more timely and insightful strategic risk adjustments. It also helps put everyone on the same page from a risk management perspective, allowing the independent risk management function to focus its attention on enterprise-level risk issues and on instances where its views differ from those of the business units.

A key to sustainable risk governance is developing, attracting, and retaining talent. Regulators are increasingly looking at staffing levels, training, compensation structures, and performance management programs to determine if they promote a sound risk culture. Also, proper messaging of risk considerations in compensation and training programs is important—including clear messaging about negative repercussions where warranted.

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Here are some specific action steps that can help banks achieve more sustainable and effective risk governance:

- Assess the depth of risk ownership at the firm. If it stops with top executives in the first line, then this line of defense may be the weakest link. In the business units, both executive leadership and rank-and-file employees need to clearly understand the relationship between the risk appetite statement, the system of limits, the risk framework, and the work they do every day. An assessment can identify just how deep that understanding goes.
- Conduct a gap analysis to assess if processes are in place to determine compliance with all applicable policies, procedures, and processes established by the second line of defense.
- Determine if sufficient information systems exist to appropriately manage and assess a firm's significant risks, that the required information is available to all three lines of defense, and that the board of directors is kept fully informed to allow for credible challenges to management's recommendations and decisions.

2. Culture and ethics

Many of the problems and failures during and after the financial downturn—some of them criminal—were rooted in poor cultural foundations. In response, US banking regulators, the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision are increasingly focusing on the importance of culture at banking institutions.

A sound culture and well-understood ethics framework can help reduce regulatory problems, fines, and litigation. However, instilling an appropriate culture should not be viewed as a compliance exercise or a standalone work stream or project. Rather, it must be a fundamental firm-wide mindset. Firms should not just be asking "is it legal?". They should be asking "is it consistent with our values for treating our customers and the community?" Over time, good ethical behavior will enhance the firm's reputation and trust.

Our experience suggests that the key elements of a sound culture include:

- Appropriate "tone from the top," including board and executive management's articulation and oversight of values, conduct, and behaviors.
- Directors and an executive team who work to determine whether there is a strong and consistent "echo from the bottom."
- Compensation and promotion practices that balance revenue and profitability goals with ethical behavior and conduct; there should be strong incentives for desired behaviors and clear negative consequences for improper conduct—whether deliberate or just irresponsible.
- A risk appetite statement that contains clear and well-understood values and conduct standards; all employees at the firm should be held accountable for actions that are inconsistent with the standards.
- An effective three lines of defense governance framework that incorporates the bank's culture, ethics, and conduct standards.

According to a report on Banking Conduct and Culture published in July 2015 by The Group of Thirty,[1] "Desired values and conduct should be reflected in the daily habits and practices of employees—how they work; how they are evaluated; who is hired, promoted, and rewarded; and how employees act when managers are not present and when matters of personal judgment arise."

There is little debate about the importance of a sound culture. The issue is how to achieve it. It is a significant challenge to measure and identify if a firm's values and ethics are well-understood and followed by everyone in the firm, particularly in light of revenue goals and other pressures. Development of inappropriate "sub-cultures" in individual business lines is not uncommon and can lead to reputational damage that taints the whole firm.

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For most firms, assessing and instilling appropriate cultural behaviors and values consistently throughout the entire organization remains a work in progress. Specific actions include:

- Frequent communications from the board and executive management that articulate the firm's values, ethics, and beliefs.
- Employee and customer surveys that measure cultural elements and identify behaviors that are contrary to the firm's cultural foundation.
- Analysis by business lines and independent risk management of problems to determine if the underlying cause is cultural failures.
- Regular assessments by internal audit that look across the enterprise to identify thematic issues that may be rooted in cultural problems.

Cultural change is one of the toughest challenges in business, but it is worth the effort. Effectively implementing a sound firm culture can boost a firm's reputation, reduce risk, and help build trust. Over time, that can provide a significant competitive advantage. Conversely, breakdowns attributed to weaknesses in culture could bring into question whether a firm is too large and complex to manage effectively, which might then result in pressure to simplify and downsize.[2]

3. Capital planning and stress testing

In the wake of the financial downturn, regulators have been pushing banks to formalize their capital-planning and stress-testing processes to help ensure their ability to weather future severe downturns while continuing to lend. Banks' ongoing efforts to develop and integrate these critical processes into day-to-day operations has significantly influenced their key decisions and business strategies.

In its first iteration, the Federal Reserve's supervisory efforts to review capital plans through its Comprehensive Capital Analysis and Review (CCAR) program might have seemed like little more than a way to push banks to hold more capital. However, over time it has become much more than that. CCAR now provides an essential view for the FRB to understand how well risk management within a firm is actually operating. In particular, the elements of capital planning provide insights about how the first line of defense (front-line units), second line (independent risk management), and third line (internal audit) are functioning to ensure the organization is well-controlled and well-managed. CCAR provides transparency into how the firm debates and makes decisions about business strategy, the implications of stress test results, and planned capital actions. Also, CCAR helps the FRB understand how the board sets the firm's risk appetite and how it oversees and challenges senior management.

An effective capital-planning and stress-testing process requires a firm to combine and coordinate a variety of business lines as well as functional areas—including risk, finance, and internal audit—all working in concert toward the ultimate goal of creating a credible capital plan. Along the way, institutions are required to document in detail every step of their capital-planning process, including the degree of challenge applied at each step, which helps demonstrate to regulators and other third parties that all key decisions were sufficiently debated. Further, every year regulators expect to see continued improvement in stress-testing models and capital-planning approaches as they raise the bar on what constitutes an acceptable practice.

Improved collaboration across the enterprise has helped many firms bridge silos, improve their strategic business decisions for capital optimization and risk taking, and identify new opportunities for improved risk management. Looking ahead, as their capital-planning and stress-testing processes mature, institutions should continue to transform their programs from a once-a-year fire drill to an integral part of their everyday operations, risk management activities, and strategic thinking.

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4. Recovery and resolution planning

Large financial institutions are focusing intensely on recovery and resolution planning. The purpose of such plans is to help those firms respond quickly to stress events and, in cases where a firm's response ultimately proves inadequate, to help the business be resolved in an orderly manner. FDIC Chairman Martin Gruenberg has stated that for regulatory agencies, there is no higher priority coming out of the prior financial downturn.

Recovery and resolution planning requirements for the largest banking organizations can have three distinct elements:

- *Dodd-Frank Act Title I Resolution Planning:* Large domestic bank holding companies and foreign banking organizations (FBOs) operating in the US with total assets of $50 billion or more—as well as nonbank financial companies designated by the Financial Stability Oversight Council (FSOC)—are required to prepare annual resolution plans, also referred to as "living wills," under Title I of the Dodd-Frank Act. The plans must demonstrate that the firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the US economy. These plans are evaluated jointly by the FRB and the FDIC.

  In August 2014, the FRB and FDIC, for the first time, provided firm-specific feedback to institutions on the credibility of their resolution plans. They identified serious shortcomings and warned that if the firms failed to address those shortcomings in their 2015 plan submissions, the agencies would exercise their authority under the Dodd-Frank Act and find the plans "not credible." Such a finding could lead to increased capital and liquidity requirements, restrictions on growth and business activities, and possibly even require divestitures in the long run. The agencies noted that prior plan submissions included unrealistic or inadequately supported assumptions and that firms had failed to take—or even identify—actions that would improve their resolvability. Through subsequent communications in late 2014 and early 2015, the agencies clarified their expectations for 2015 submissions and established a July 2017 deadline for firms to be operationally ready to be resolved.
- *Recovery Planning:* The eight largest domestic bank holding companies are required to proactively plan and prepare for severe stress. This includes developing a menu of actions that would enable a firm to respond to a wide range of internal and external stresses. These plans are evaluated by the FRB. In September 2014, the FRB issued SR 14-8 establishing broad expectations for this requirement, including incorporation of recovery planning into a firm's business-as-usual corporate governance, risk management, and operating processes; linkage of recovery planning to other contingency and strategic planning activities; and testing of recovery option effectiveness.
- *Insured Depository Institution (IDI) Resolution Planning:* Insured depository institutions (banks and thrifts) with $50 billion in assets are required to prepare annual plans that would enable the FDIC, as receiver under the Federal Deposit Insurance Act, to resolve the institution, should it fail, in an orderly manner that minimizes losses to creditors including the deposit insurance fund. These plans are evaluated by the FDIC. In December 2014, the FDIC issued new guidance that substantially increased expectations for these plans, including direction about the elements that should be discussed in a fully developed resolution strategy and cost analysis; clarification regarding assumptions made in the plan; and a list of significant obstacles to an orderly and least costly resolution that institutions should address.

In July 2015, the 12 most complex banking organizations operating in the US submitted their 2015 annual Title I and IDI resolution plans to the regulatory agencies and are currently awaiting feedback. Remaining firms covered under the resolution planning rules must submit their plans by December 31, 2015. Earlier in the year, the FRB initiated Supervisory Assessment of Recovery and Resolution Preparedness (SRP), an ongoing evaluation of capabilities for recovery and resolution, similar in scope and importance to the Comprehensive Capital Analysis and Review (CCAR) and the Comprehensive Liquidity Assessment and Review (CLAR).

Addressing impediments to recoverability and resolvability in large, complex firms often requires substantial changes to organizational structures and business practices. One of the most pervasive challenges is the financial and operational interconnectedness within such organizations. Reducing interconnectedness is often time-consuming, costly, or both.

To date, much of the focus in this area has been on the annual resolution plans themselves. However, the focus is now starting to shift. For resolution planning, regulators have expanded their efforts from a review of the annual submissions to more broadly assessing the capabilities of the firms in question. This means that in order to meet regulatory expectations, a firm must not only present a well-supported resolution strategy, it must also make necessary changes to its legal structure and business practices that would enable it to be resolved under that strategy (as well as other failure scenarios and resolution approaches).

The Federal Reserve recently proposed a total loss absorbing capacity (TLAC) rule that would mandate several required features of a global systemically important banking organization's (GSIB) structure and resolution capabilities. The proposed rule would specify the minimum amount of combined capital and debt a firm should have in order to facilitate a recapitalization during resolution, as well as a "clean holding company" requirement. The proposal seeks to ensure a parent company could go through bankruptcy, yet still have sufficient standby funds to recapitalize its material subsidiaries from the clean holding company without legal challenge. This would enable the firm to continue critical operations for its customers and the financial system without requiring government intervention or funds. GSIBs are evaluating the impact of this proposal on the types of debt currently on their books that might be eligible to meet TLAC requirements. They are also evaluating how their holding companies might need to be restructured to meet the proposed requirements.

For recovery planning, firms are expected to move beyond identifying theoretical plans to demonstrating their preparedness to be resolved. To do this, many firms will need to build out the details of their recovery plan options and then take the required preparatory actions to ensure they can execute those options under stressed conditions. In order to demonstrate preparedness both for recoverability and resolvability, firms will need to test their recovery and resolution plans using rigorous testing and simulations to document their capabilities and help identify areas for potential improvement.

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5. Enhanced prudential standards for foreign banking organizations

Beginning July 1, 2016, every FBO with more than $50 billion in assets in non-branch US legal entities will be required to have an operating intermediate holding company (IHC)—as well as a US risk committee—to oversee its combined US operations, which includes the IHC and all branches. In this reorganized form, FBOs will be subject to EPS for capital, liquidity, governance, and risk management.

Even with the final deadline looming, key decisions are still being made about how to establish risk governance that appropriately balances global versus local decision making. At the top of the list are concerns from the FRB about potential conflicts of interest for employees that have a “dual hat” role at the local and global levels. Also, intermediate deadlines are nearly here for establishing IT systems and reporting that provide a US view of financials and risk for the IHC and branches.

Creating new entities that for the first time combine banks, broker-dealers, and other nonbank entities into a single, US holding company is a substantial challenge that requires a transformational effort across US operations. In particular, aggregating risk across the IHC and branches into a combined US view presents significant data and translation challenges that most firms have never faced before. The good news is that creating a new organization also provides an opportunity for a firm to take a fresh look at each element of its US operations and then decide whether that element should be streamlined or perhaps discontinued if it is not creating enough value for the parent.

Navigating through this vast and complex set of requirements is essential to prospering in the new regulatory environment. For many FBOs, the key ingredients for success are:

- Embracing the new US governance model and changing the firm’s culture to fit.
- Expanding and redoubling efforts on data and MIS.
- Communicating frequently and effectively both to regulators and internal stakeholders about key decisions, accomplishments, and future direction.

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6. Consumer protection

The Consumer Financial Protection Bureau (CFPB) has transitioned from a new regulatory agency into a force that is transforming the landscape for consumer financial products. As such, the bureau's actions and direction are of great importance and interest to banks and nonbanks alike.

A wide range of products are affected by CFPB activities. One example is mortgage lending, including transformative requirements for "ability-to-pay underwriting" and enhanced servicing standards, along with new integrated mortgage disclosure requirements. Another example is credit card lending, which faces new disclosure requirements and fee limits, as well as continued focus on add-on products sold through third-party vendors. Transformation also appears to be underway in other business lines, such as indirect automobile lending, where new loan pricing practices are being driven by CFPB settlements. In addition, the CFPB is following a now familiar pattern of announcing a focus on student lending and servicing.

The principal tools that the CFPB continues to use to fulfill its consumer protection mandate are: the adoption of new rules; enforcement actions involving high dollar restitution requirements and fines; and collection of consumer complaint data and other market information. Two recent areas of CFPB focus include enforcement actions related to pricing discrimination in automobile finance and illegal student loan servicing practices. More actions like these can be expected in the future; however, legacy issues also remain a focus in areas such as marketing of credit card add-on products, overdraft programs, payday loans, prepaid products, credit reporting, and debt collection. The CFPB's attention and actions have been targeted at both banks and nonbanks consistent with its mandate to level the playing field among market participants.

Another focus area for the CFPB is market innovations. For example, payment processing is evolving quickly, prompting the CFPB to address innovations such as the digital/mobile wallet in its proposed rule about prepaid financial products.

Banks and nonbanks are both generally increasing their spending on CFPB compliance; however, some continue to face challenges in meeting the bureau's expectations. Achieving continued improvement in Compliance Management Systems (CMS) will require vigilance and a "compliant" tone from top leadership—supported by effective policies, procedures, staffing, training, data governance, and audit. One significant ongoing challenge for many institutions is aggregating, analyzing, and reporting customer-level data, which can help identify, escalate, and remediate compliance matters such as those related to unfair, deceptive, or abusive practices; fair lending; service member civil relief; and consumer complaint handling. Although regulated banks are very familiar with these kinds of basic requirements, many nonbanks likely won't have the same level of familiarity.

Regulated entities—whether banks or nonbanks—are all expected to embed strong compliance programs into their systems, thereby lowering the chances of problems occurring and helping to identify, escalate, and remediate problems that do occur. To better manage its CMS, a firm should assess and consider enhancing its entire compliance infrastructure—including policies, procedures, systems, controls, testing, training, and audit—in a way that is sustainable and repeatable.

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7. Cyber threats

Cybersecurity is a major issue in banking and a top priority for regulators. However, because technology threats evolve too quickly to legislate against, regulators are largely addressing the challenge by expecting banks to adhere to world-class standards from organizations such as the National Institute of Standards and Technology (NIST).

In 2014, the NIST released a preliminary framework that provides guidelines and leading practices for thwarting cyber threats. Banks are expected to incorporate these and other leading standards and practices into their cybersecurity programs. Those that fail to do so face action from regulators, which have broad authority to ensure banks have adequate governance and risk management capabilities—including the ability to effectively manage cyber risks. Regulatory scrutiny is especially high for systemically important financial institutions (SIFIs), which are expected to follow the highest possible cybersecurity standards.

On March 30, 2015, federal banking regulators through the Federal Financial Institutions Examination Council (FFIEC) issued a bulletin warning institutions of the growing trend of cyberattacks designed to obtain online credentials for the purpose of theft, fraud, or business disruption. The bulletin also recommended specific techniques to mitigate risk.[3] A few months later, the FFIEC introduced its Cybersecurity Assessment Tool (CAT),[4] which allows banks to assess their cybersecurity capabilities against a standard framework and maturity model, helping them identify key risk areas and opportunities for improvement.

To stay in front of cyber threats, banks need to do more rigorous testing; establishing policies, procedures, and controls is not enough. Effective cybersecurity has three stages:

- *Secure*. Getting controls in place.
- *Vigilant*. Monitoring and adjusting for new threats.
- *Resilient.* Responding effectively when an attack occurs.

Many organizations focus on the first stage, but forget about the last two once their systems have been secured. That's a mistake. Cyber threats are constantly evolving so firms need to keep looking for vulnerabilities and making adjustments. Also, every organization is vulnerable to attack—no matter how good its security is—so it is important to test not only its controls but also how the organization responds to a cyber crisis.

Going even further, regulators have indicated that banks should expand their disruption scenarios beyond their own boundaries to include potential weak links such as customers, third-party vendors, and critical infrastructure components. This interconnected view may require changes to strategic plans and corporate culture.

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8. Data quality, analytics, and reporting

Expectations related to data quality, risk analytics, and regulatory reporting have risen dramatically since the financial downturn. At a minimum, regulators now expect reporting for capital, liquidity, and resolution planning to be more timely, accurate, and precise. Simply having the raw data is not enough; firms must be able to aggregate the data and perform advanced analysis in order to inform key decisions.

The largest banks have long faced these higher expectations, which were formally laid out in international guidance by the Basel Committee for Banking Supervision in 2013 (BCBS 239). However, in recent years regulatory reporting problems across the banking industry have more broadly called into question the credibility of data used for capital distributions and other key decisions. The FRB in particular is requesting specific details on the data quality controls and reconciliation processes that firms are using to determine the accuracy of their regulatory reports and capital plan submissions. The Federal Reserve recently proposed requiring specific attestation requirements by CFOs or their equivalents for the key stress-testing reports.[5]

Improving the quality and timeliness of data and analytics requires proper planning and direct attention from management, as well as significant investment in IT infrastructure and the firm’s subject matter expertise. At most firms, there are significant opportunities to retire costly legacy systems, reduce headcount for manual interventions, and avoid reputational risk with regulators and the public. Having more timely risk data and analytics is essential for making risk/return tradeoff decisions that maximize resiliency and shareholder returns.

Firms may want to consider a top-to-bottom evaluation of their governance and systems infrastructure for risk and finance data to ensure they have the capabilities necessary to meet the ever-expanding needs of internal stakeholders, investors, and regulators over the long run. Such an evaluation should focus particular attention on past data quality issues and the degree of manual intervention required to address them.

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9. Model risk management

The use of sophisticated financial models for making key decisions in the banking industry continues to accelerate. In 2011, the FRB and OCC issued guidance codifying the need for firm-wide standards about how such models are developed, validated, and used—and requiring that model-related risks be well-understood. This guidance now represents the minimum of what regulators expect in the area of model risk management.

An organization should take great care to determine whether its model risk management framework is well-understood throughout the organization.

Regulatory pressure has intensified even further over the past few years. In particular, regulators have been working hard to ensure that firms:

- Define clear roles for managing model risk across the three lines of defense.
- Establish comprehensive model inventories.
- Validate and review models with appropriate frequency.

The FRB and OCC gain insights about the effectiveness of model risk management practices and approaches through both targeted reviews and annual CCAR exams.

It can be a major undertaking to move from a less formal approach to a more formal, comprehensive, and fully documented approach that includes active oversight by the board as well as full engagement by the business lines, corporate risk groups, and internal audit. Key activities include establishing specific policies for identifying, developing, validating, and using models; defining the roles of the three lines of defense; and communicating the approach throughout the organization. These activities will likely require a significant investment of time, people, and resources; however, the resulting ability to measure and aggregate risk can help a firm determine its risk appetite and provide the board with a better understanding of the risks and limitations of key models used in the firm's decision making. What's more, the process of establishing a formal approach to model risk management can help ferret out unauthorized use of the models within the organization, which can pose its own unique risks.

An organization should take great care to determine whether its model risk management framework is well-understood throughout the organization. This includes communicating the model risk management process to each of the three lines of defense, conducting a complete model inventory, thoroughly documenting the models, and establishing deadlines for model validation and review. These activities may require significant effort, depending on the framework's current maturity level. They may also require specialized subject matter experts to help execute the program and avoid setbacks that could undermine the credibility of key model-based decisions, such as the degree of financial risk to undertake and the amount of capital to distribute to shareholders.

10. Credit quality concerns

Although credit quality indicators remain favorable overall, regulators are increasingly concerned about a gradual erosion in underwriting standards. In particular, regulators have voiced specific concerns about leveraged lending and auto finance underwriting.

Based on lessons learned from the financial downturn, regulators now expect banks to develop better tools to measure and monitor risk. This includes more rigorous credit portfolio analysis, increased stress testing, and more robust concentration management. The expected outcome of these enhanced portfolio management practices is a better understanding of the bank's risk exposure and loss volatility in a severe downturn. Regulators expect a bank to assess its stress test results against its risk appetite and to make appropriate adjustments as needed.

In leveraged lending, regulators are expressing concern about rising leverage levels, covenant lite structures, and the inability to demonstrate that a borrower can deleverage over time. In auto finance, regulators are warning lenders about extending loan terms and increasing loan-to-value ratios, especially for subprime credit. Oil and gas lending has also been receiving more scrutiny lately in response to falling oil prices. Adding to these concerns is the ongoing low interest rate environment, which pressures bank managers to compromise on risk in order to book assets with higher yields. Competition for loans has increased as the financial condition of banks has improved.

Regulators expect a firm to be able to clearly demonstrate how its business line and portfolio level limits and standards align with its overall corporate risk appetite. Standards and practices that don't appear consistent with the firm's risk appetite statement will likely be criticized.

Here are some specific actions that firms can consider taking now to reduce the likelihood of trouble down the road:

- Understand the increased regulatory expectations for portfolio management, including portfolio stress testing and concentration management.
- Determine compliance with interagency guidance for leveraged lending and engage with regulators to identify and address emerging industry regulatory issues.
- Continue to build appropriate portfolio credit risk metrics, especially in portfolios with a high level of loss volatility, such as real estate construction and development lending. Invest in the technology necessary to enable state-of-the-art monitoring and management of credit exposures.
- Don't lose sight of credit discipline during the good times, which is the point when questionable, poorly structured loans are often booked.

The old credit maxim that "the worst of loans are made during the best of times" has been shown to be true over and over again, yet it is often recognized only in retrospect. During this phase of the credit cycle, bank managers and directors must be extra diligent about ensuring the inherent risk in their firm's portfolio does not stray from its risk appetite. The rewards for maintaining credit discipline as market standards deteriorate are far fewer losses during the downturn and a superior competitive position during the next credit cycle.

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11. New risks from financial innovation and migration of activities

As new regulatory requirements driven by the Dodd-Frank Act have gone into effect, some banks have exited markets and changed how they participate in other markets, often leading to an influx of nonbank financial companies that have tended to be less regulated. This shift is prompting regulators to examine the potential risks to overall financial system stability. What's more, it creates new risks and challenges for the banks themselves, since exiting an existing market is rarely easy or instantaneous; also, shifting participation to another market presents a whole new set of risks.

Transitioning out of a market might make sense strategically, but the practical challenges of making it happen can be significant.

The Financial Stability Oversight Council (FSOC), which was established by Dodd-Frank and charged with identifying financial stability risks, raised concerns about several of these changes in its 2015 Annual Report. Two high-risk areas specifically cited by the FSOC report were central counterparties and mortgage servicing.[6]

- *Central counterparties (CCPs):* This topic is receiving increased regulatory attention from the FSOC for the first time. In the wake of the financial downturn, regulators began requiring standardized over-the-counter (OTC) derivatives to be cleared through CCPs. Yet according to the FSOC report, while regulators have taken "significant steps … to promote strong risk management at systemically important CCPs," the FSOC believes the failure of a CCP could pose a threat to overall financial stability.[7] According to US Commodity Futures Trading Commission (CFTC) Chairman Timothy Massad, roughly 75 percent of interest rate and credit default swaps, as measured by notional value, are now being cleared through CCPs, compared to only 16 percent in December 2007[8]—increasing the implications of a CCP failure for banks that participate in these markets. The FSOC recommends that the FRB, CFTC, and SEC review the "adequacy of margining, stress testing, enhanced transparency and disclosures, and cyber resilience" for CCPs, with a particular focus on bank-CCP interactions and risk management. More specifically, the FSOC recommends that agencies evaluate how banks and other clearing members "manage and account for their potential exposures to the full range of CCPs, both foreign and domestic, in which they participate."[9]
- *Mortgage servicing assets (MSAs):* Under an October 2013 final rule adopted by US regulators implementing the Basel III framework, MSAs are limited to 10 percent of common equity Tier 1 capital. MSAs in excess of this threshold must be deducted from common equity. What's more, starting in 2018, banks will be required to apply a 250 percent risk weight to the portion of MSAs not deducted from the calculation of common equity Tier 1 capital.[10] In response, banks have sold a large amount of MSAs to nonbank mortgage servicers in recent years. However, exiting the mortgage servicing market can be a long and difficult process that may give rise to due diligence burdens for banks seeking to restructure their operations through sales and divestitures. For the sake of financial stability, the FSOC noted the potential significant negative consequences of a failure for market participants and recommended that state regulators continue to monitor nonbank financial firms that acquire MSAs—and that they collaborate with the CFPB and Federal Housing Finance Agency (FHFA) on "further developing and implementing prudential and corporate governance standards" such as capital, liquidity, and risk management oversight for these companies.[11]

Looking forward, as banks continue to evaluate their operations and consider exiting or amending their participation in selected markets, they must stay on top of new and emerging risks from such decisions. Transitioning out of a market might make sense strategically, but the practical challenges of making it happen can be significant.

12. Linking regulatory strategy to business strategy

When tackling regulatory change, many organizations have traditionally operated in reactive mode, only changing in response to regulatory orders, examination comments, or other types of intense regulatory pressure. However, a number of organizations have recently started shifting toward a more proactive approach to regulatory strategy by establishing a stronger linkage to business strategy.

A forward-looking regulatory strategy creates opportunities to better align regulatory responses with business objectives. It can also improve efficiency and reduce regulatory criticisms. By identifying connection points between your regulatory and business strategies—instead of managing regulatory strategy as a side activity—you can discover ways to achieve common objectives more efficiently and align compliance activities with your organization's broader goals.

The first step when linking regulatory and business strategy is to clearly define and document each strategy, establishing detailed goals and action plans on how to best allocate limited resources. Other issues to consider include short- and long-term goals, your organization's risk appetite, and external factors such as technology advances and politics. Politics can have a particularly high impact, especially during the period leading up to a presidential election.

Keys to effective strategic alignment:

- Build a team that brings varied viewpoints on both regulatory and business goals.
- Actively look for ways to achieve both kinds of goals through shared actions.
- Share what you learn across organizational boundaries, highlighting how the two strategies are aligned for overall success and thus encouraging the entire organization to understand and drive toward common results.
- Encourage new ideas for trial runs that enhance buy-in and foster a willingness to innovate and seek joint solutions.
- Hold both plans to the same level of accountability through ongoing review and reporting.

Institutions often object to making changes just to satisfy regulators—and rightly so. However, finding ways to align regulatory strategy with business strategy is a win-win, helping you achieve compliance while at the same time improving your overall business performance.

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Endnotes

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[3] OCC 2015-19, "Cybersecurity: Cyber Attacks Compromising Credentials Joint Statement," Office of the Comptroller of the Currency, U.S. Department of the Treasury.

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Moving forward

In 2016, meeting regulatory expectations will require a multi-disciplinary focus. This is partly due to the connectedness of the risks and how technology has permeated the way banking services are delivered, managed, and supervised. To be effective, design of a regulatory compliance program should be linked to risk management and overall corporate strategy.

Getting it right requires an enterprise-wide cultural commitment that strikes a balance between satisfying regulators and achieving strategic goals for all stakeholders. Expectations for transparency and accountability are higher than ever as the industry operationalizes plans designed in response to Dodd-Frank regulations, while at the same time responding to economic and technological changes. The industry is moving toward a predictive environment that is light years beyond the reactive responses of past regulatory regimes. This was further highlighted in a November 4, 2015, speech by Janet Yellen, chair of the Federal Reserve Board, to the Committee on Financial Services, US House of Representatives, in which she stated that regulators "have made changes in our supervision that now allow us to supervise large financial institutions on a more coordinated, forward-looking basis." In this new environment, data analytics has become an essential capability.

Regulatory compliance and risk management can no longer be managed within a silo or single line of defense; rather, it must be embedded in the entire organization's underlying culture and ethics. Finding ways to tackle these new regulatory expectations will be transformative for the banking industry.

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