



cutting through complexity

FINANCIAL SERVICES

Evolving Banking Regulation

Americas Edition

Toward a new
management vision
March 2014

kpmg.com



ABOUT THIS REPORT

This report is part of a regional series developed by KPMG's network of regulatory specialists. The insights are based on discussions with clients and KPMG professionals assessments of key regulatory developments.

For other regional reports, please contact fsregulation@kpmg.co.uk or visit www.kpmg.com/regulatorychallenges.

CONTENTS

02
Executive Summary

04
Regulatory Pressure Index
This heat map illustrates the scale of the challenge posed by key areas of regulatory reform.

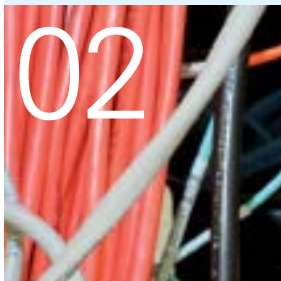
32
Abbreviations

33
Acknowledgments

CHAPTERS



6
**Introduction
Regulatory Environment**
An update on the Americas' region regulatory reforms.



10
**Strategic and
Structural Change**
The cost of doing business is expected to dramatically increase due to structural change requirements.



14
Conduct and Culture
Conduct and culture are linked – banks must ensure that their employees do what is right.



18
**Data and Reporting
Aggregation**
Banks face wide-ranging demands from regulators and others for reporting and disclosures.



24
Risk and Governance
There is still much more to be done as banks significantly upgrade governance and risk management practices.



30
Canada



31
Latin America



32
Conclusion

The regulatory environment is forcing banks to rethink their operating model. Long-standing weaknesses in data quality and aggregation capabilities in addition to outmoded risk governance structures are making it difficult for the industry to change.

Executive Summary

Despite a broadening economic recovery in the U.S., banks are still struggling to regain their footing, from both a revenue generation and a regulatory compliance standpoint. The more stringent regulatory environment and current market conditions are linked. Achieving returns that are consistently greater than the cost of capital remains a challenge, given the cumulative effect of higher capital requirements, activity restrictions and increased compliance costs.

Financial institutions need to find new areas to generate revenue, yet they are hampered by the demand to comply with an ever-growing regulatory regime that shows little sign of relaxing. Bank executives are struggling with how to rise above the wave of regulation to focus on revenue growth. Until banks fully embrace a new, more risk-aware culture and enact more far-reaching changes to their control functions and governance structures, the chance of rising above the wave of regulation may be slim.

In the 2013 report on Evolving Banking Regulation, we highlighted the strategic and operational challenges the increasing regulatory standards posed for banks in the Americas. Five key lessons for the future that we highlighted last year bear repeating:

A culture shift towards greater

business integrity – This does not mean embracing timidity but carefully weighing the risks and rewards of a given business path that is based on probity and trust.

A holistic approach that avoids placing compliance in a silo – Obeying the spirit of the law requires a deep understanding of the rules' intent from top to bottom and throughout the organization, not just in the compliance department or the office of the General Counsel.

A talent plan that focuses on nurturing or acquiring the right skills and business attitudes – HR departments must play a crucial role in helping to select job candidates of the best caliber for every vacancy, however junior. For current employees, thorough training in

compliance with the new regulations is essential, and remuneration should also be tailored appropriately.

A compliance approach that is fully integrated into corporate strategy – Every business option needs to be evaluated from the standpoint of ethics as well as profits.

A significantly greater volume of business data than before – In complying with the new reporting requirements, banks will need to invest in data collection, analysis and delivery which should ultimately enable them to run their companies (and regulators to supervise) more effectively.

This year we are again focused on the impact of regulation and examine what additional rules may be expected in the coming year. However, we have refined our focus to four key areas:

- Strategic and Structural Change
- Conduct and Culture
- Data and Reporting Aggregation
- Risk and Governance.

The regulatory environment is forcing banks to change their operating model, and undertake a fundamental examination of their overall strategy and structure. However, long-standing weaknesses in bank data quality and aggregation capabilities, in addition to outmoded risk governance structures, are making it difficult to address the many challenges the industry faces. Moreover, the loss of confidence the industry suffered following the crisis, and the ongoing scrutiny the industry faces as a result, have created an environment of zero tolerance for error.

At the end of the day, banks must ensure that their employees are "doing the right thing." But they must also know when they

are not. This is no easy task, and the ever-intensifying regulatory landscape only makes it harder to achieve.

Given the differences in regulatory intensity in the U.S., Canada and Latin America, we have created separate sections for Canada and Latin America. Canada's banking market is as highly developed as that of the U.S. and withstood the financial crisis relatively well. Some of its largest banks are in a strong position to gain market share in the U.S. and Latin America. Many Latin American banks are as profitable as their Canadian counterparts and, in most of the large Latin American economies, the regulatory authorities are tightening their

supervision. All the major countries in this report are responding to the requirements of the Group of Twenty economies and the Basel Committee on Banking Supervision to strengthen their liquidity positions, capital, and leverage ratios.

But the main focus of this report is the U.S. and the steps that banks there are taking to meet ever-increasing regulatory demands. Without far-reaching changes in bank culture and significant improvements in risk management and governance systems, banks will have a hard time keeping up with the growing demands of regulators, investors, and indeed, the public at large.

BANKS NEED TO RESPOND TO MULTIPLE PRESSURES

CUSTOMERS

- Fewer, more expensive products
- More transparency but less flexibility
- Offer what the regulator allows, not necessarily what they want or need

INVESTORS

- Will not put up more capital without adequate returns
- Prepared to accept lower returns if risk is correspondingly lower
- Debt coupons will need to reflect the threat of bail in

REGULATORS

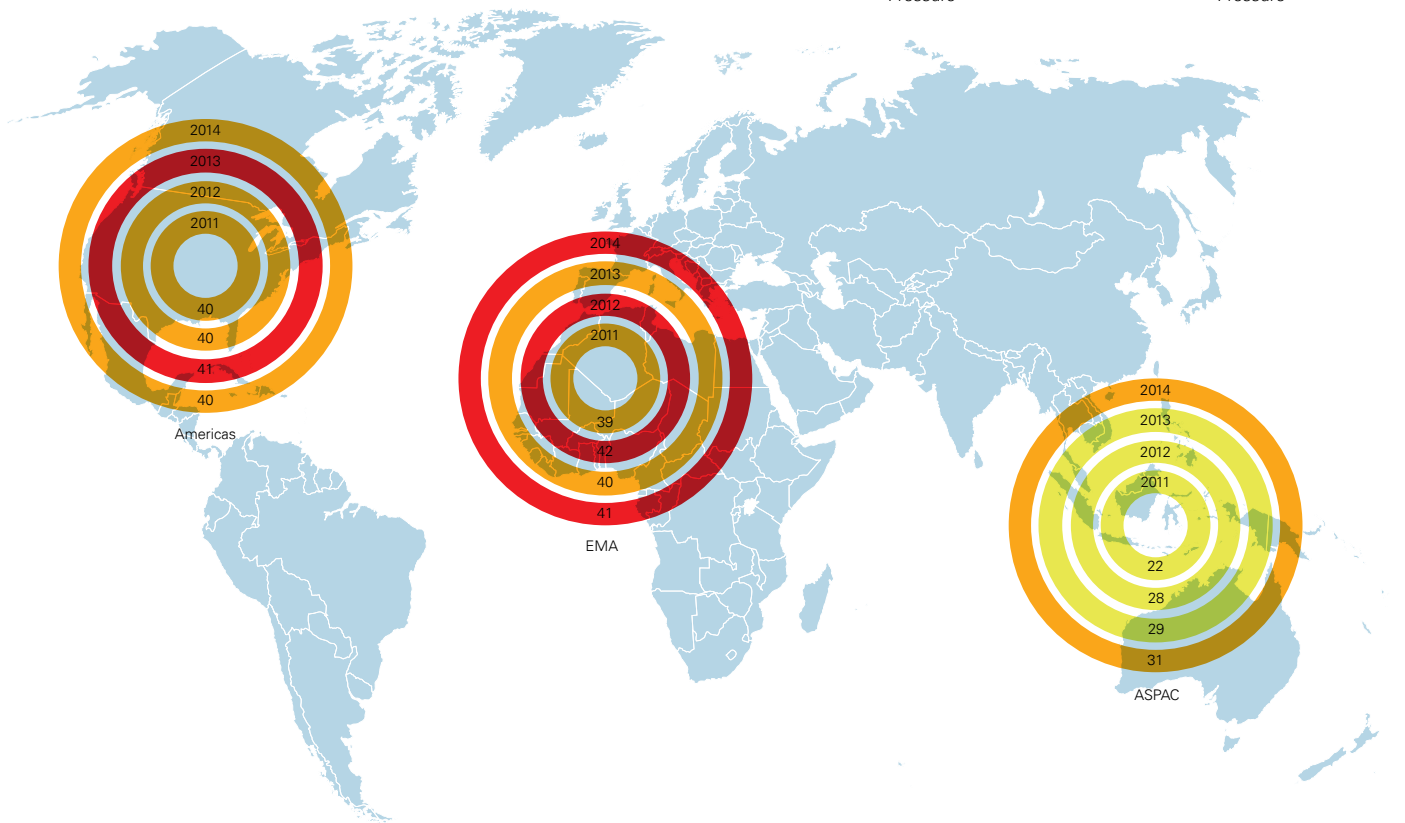
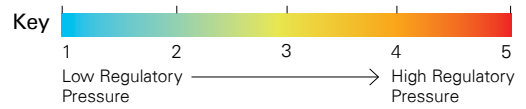
- Regulatory demands increase the cost of capital
- Mistrust of banks, capital markets and shadow banking
- Emphasis on personal responsibility and improved risk governance



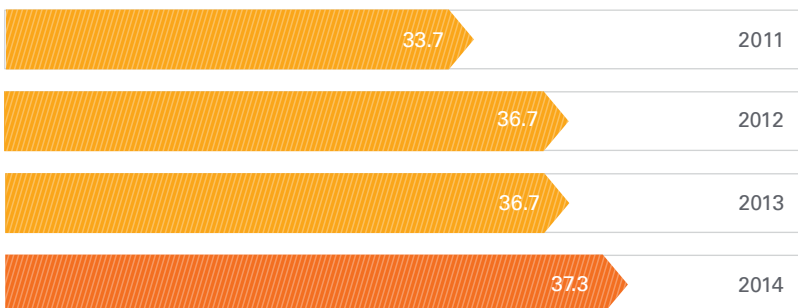
Source: Evolving Banking Regulation, EMA Edition, KPMG International, February 2014

Regulatory Pressure Index

REGULATORY CHANGE – REGIONAL DIVERGENCES



THE GLOBAL PRESSURE CONTINUES TO GROW



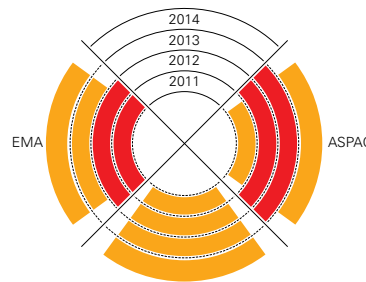
Note: The regional numbers are the sum of the scores in each region across the ten individual areas of regulatory pressure. The global pressure index is the (unweighted) sum of the scores for each region, divided by three.

CHANGES IN THE REGULATORY PRESSURE INDEX

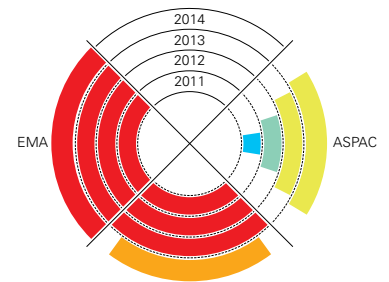
The regulatory pressure index on the Americas has lessened slightly this year in the area of systemic risk due largely to U.S. Treasury default fears abating. Systemic risk is higher in Europe, because the risk of contagion is greater there than in the Americas. The regulatory pressure index in the Americas in all other respects is unchanged from last year, with capital and governance rated a five, the highest level.

Pressure on governance standards in the Americas shows no sign of abating; if anything, pressure is growing on banks to improve their governance structure. Similarly, supervisory pressure is as strong this year as last, particularly in view of the welter of new reporting requirements imposed on banks. In all other respects—capital, conduct and culture, governance, market infrastructure, financial crime and taxes, accounting and disclosure, remuneration—the regulatory pressure index is expected to remain unchanged for the foreseeable future.

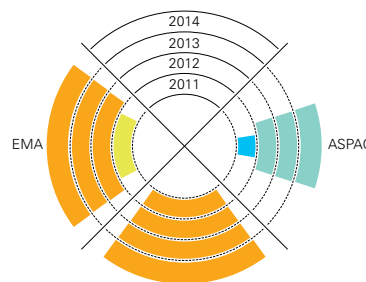
AREAS OF REGULATORY PRESSURE



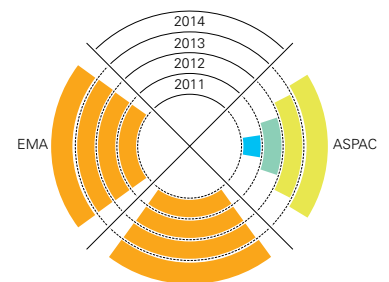
LIQUIDITY



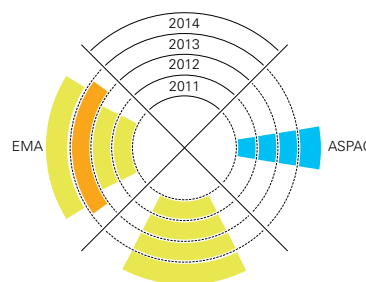
SYSTEMIC RISK



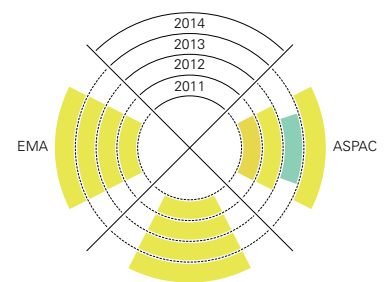
CULTURE & CONDUCT



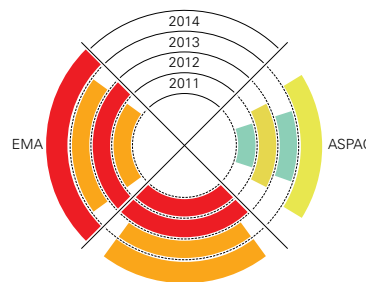
MARKET INFRASTRUCTURE



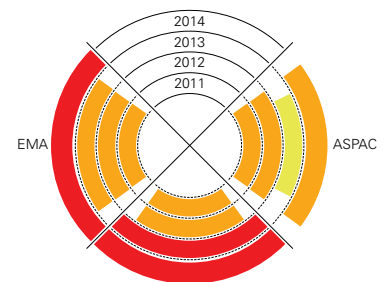
REMUNERATION



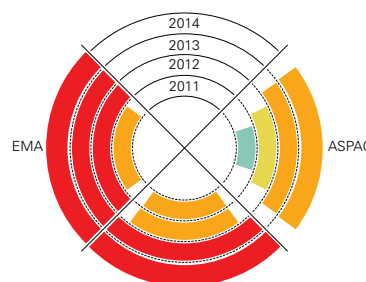
ACCOUNTING & DISCLOSURE



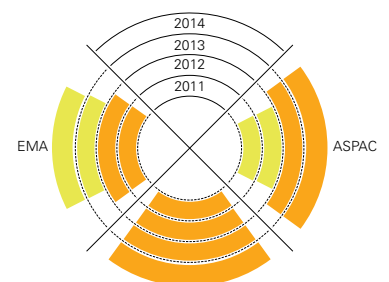
SUPERVISION



GOVERNANCE



CAPITAL



FINANCIAL CRIME & TAX

Revenue expansion will be difficult given the regulatory environment, particularly when coupled with mounting litigation costs related to the financial crisis.

01 Introduction Regulatory Environment

The global financial crisis that began in 2007 continues to cast a long shadow over the banking industry, subjecting it to intense regulatory and public scrutiny. Indeed, the expectations of regulators regarding the governance and conduct of financial institutions are only heightening. Daniel Tarullo, the Federal Reserve Board Governor in charge of bank supervision, told a Congressional panel in February: “The Federal Reserve’s regulatory program in 2014 will concentrate on establishing enhanced prudential standards for large U.S. banking firms and foreign banks operating in the United States pursuant to section 165 of the Dodd-Frank Act and on further enhancing the resiliency and resolvability of U.S.-based global systemically important banks.”¹

Those who hoped the regulatory pendulum would eventually moderate have been sorely disappointed. Welcome to what might be termed “the new regulatory normal.” In the rest of the Americas, regulators are taking a somewhat less stringent approach to their countries’ banks, but they have nonetheless ratcheted up the pressure, in keeping with international standards set by the Basel Committee and the G20 group. The supervisory environment is summarized in KPMG’s regulatory pressure index (see pages 4 and 5), which shows that in only one area, systemic risk, have KPMG’s partners lowered the index a notch. In every other respect, the regulatory pressure on the banks is as strong as ever. The index is at the maximum of five with respect to banks’ capital and governance, areas that are expected to continue to remain in the spotlight in 2014.

¹ <http://www.federalreserve.gov/newsevents/testimony/tarullo20140206a.htm#pagetop>





INTRODUCTION REGULATORY ENVIRONMENT

In the past year, a number of milestones were passed in implementing financial reforms of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and of the Basel Committee on Banking Supervision, including:

Enhanced prudential standards for large U.S. and foreign banks.

In February 2014, the Federal Reserve Board (Federal Reserve) finalized rules required by the Dodd-Frank Act mandating requirements for stricter liquidity, leverage, and risk management systems. Foreign banks with a large U.S. presence (over \$50 billion in U.S. assets) will be required to organize their U.S. subsidiaries under a single U.S. intermediate holding company, subject to the same risk-based capital, leverage, and capital-planning requirements applied to U.S. bank holding companies.

Volcker Rule. The Final Rule prohibits banking entities from engaging in short-term proprietary trading of certain securities and derivatives for their own account. It also imposes limits on their investments in hedge funds and private equity funds.

Liquidity rules for large banks.

The Federal Reserve, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) issued a proposed rule to implement a quantitative liquidity requirement for U.S. banks. The proposed liquidity coverage ratio would require large banks to hold minimum amounts of high-quality liquid assets that could be converted quickly to cash to cover any net cash outflows in a crisis.

Stress testing and capital planning.

The Federal Reserve and the other agencies have proposed supervisory guidance regarding internal stress testing for banks of different sizes. They also issued interim final rules clarifying how banks should incorporate the revised Basel III regulatory capital framework into their capital projections for the Comprehensive Capital Analysis and Review (CCAR) and stress testing cycles.

Emergency lending authority.

The Federal Reserve issued a proposal designed to ensure that any emergency lending program is adequately secured by collateral to protect taxpayers from loss and is for the purpose of pumping liquidity into the financial system—not to aid a particular, failing financial company.

Those who hoped the regulatory pendulum would eventually moderate have been sorely disappointed. Welcome to what might be termed “the new regulatory normal.”

Risk governance guidelines.

The OCC proposed a set of enforceable risk governance guidelines to formalize its heightened expectations for banks with \$50 billion or more in total assets. The guidelines would set new, higher minimum standards for a bank’s risk governance framework and the oversight of the governance framework by the bank’s Board of Directors.

WHAT'S NEXT?

Despite the progress made in recent months in implementing the provisions of the Dodd-Frank Act, only 205 of the 398 total required rulemakings had been finalized as of March 3, 2014², more than three-and-a-half years after it was signed into law by President Obama. Among the notable pronouncements expected later in 2014 are:

Resiliency and resolvability of GSIBs.

The Federal Reserve has stated that it will release proposed regulations designed to reduce the probability of failure of a global systemically important bank (GSIB) to levels that are below less systemically important banks. This is likely to include measures to improve the bankruptcy resolution planning process of the largest banks and to require them to maintain a minimum amount of long-term unsecured debt outstanding at the holding company.

GSIB risk-based capital and leverage surcharges.

The Federal Reserve is expected to impose additional risk-based capital surcharges on GSIBs so that, in the event of financial failure, the effect on the financial system will be minimized. Separately, the U.S. banking agencies are expected to require that U.S. GSIBs maintain a tier-1 capital buffer of at least 2 percent above the Basel III minimum leverage ratio of 3 percent.

² Davis Polk, Dodd-Frank Rulemaking Progress Report, March 3, 2014.



These regulatory developments should be seen in the context of a still-difficult business environment for U.S. banks, in spite of a broadening economic recovery. According to the FDIC, U.S. banks' ROE (return on equity) in 2013 rose above 10 percent for the first time since 2007, largely thanks to declining expenses for loan-loss reserves and cost-cutting. But revenue has remained flat since 2009 and net interest margins are at 3.2 percent, which is a historic low from where they were at the start of the financial crisis, according to the Federal Reserve Bank of St. Louis.

Banks have strengthened their balance sheets and slimmed down, but they have not been able to increase revenue overall.³ By contrast, in Canada and Latin America, banks' ROE is greater than 15 percent, potentially making U.S. banks attractive acquisition targets.

U.S. banks argue that revenue expansion will be difficult given the regulatory environment, particularly when coupled with mounting litigation costs related to the financial crisis. Additionally, U.S. banks have raised roughly \$450 billion in equity capital since the crisis, certainly no small achievement. Given all of the above, many executives say that they lack the time and energy needed to devote to overall business strategy development, because they are running hard just to keep up with an ever-expanding regulatory regime and increasing investor and public demands.

This is all the more reason for banks' executives to focus on getting their houses in order to meet the heightened expectations not only of regulators, but investors and the public as well. It will be difficult, if not impossible, for banks to increase revenue if their governance infrastructure fails to meet regulatory standards. In the sections that follow, we examine the many issues facing banks in the U.S. (Canadian and Latin American banks are covered in separate parts of the report).

It is important to understand that policymakers introduced U.S. financial reforms to enhance the stability of the financial system. However, these reforms will require the financial industry to continue to change dramatically, both in terms of structure and strategy (the next section) and of conduct and culture (the following section).

These changes are very challenging for banks, particularly in two main areas: data reporting and aggregation; and risk and governance (see the following two sections). In both respects, banks have a long way to go to overcome these challenges. If they fail to rise to the occasion, their future is cloudy indeed.

A higher minimum leverage ratio would become the binding constraint for a larger number of banks. It would therefore increasingly become a 'front stop' rather than a 'back stop' requirement.

"The financial regulatory architecture is considerably stronger today than it was in the years leading up to the crisis, but work remains to complete the post-crisis global financial reform program. In this continuing endeavor, our goal is to preserve financial stability at the least cost to credit availability and economic growth. We are focused on reducing the probability of failure of a systemic financial firm, improving the resolvability of systemic financial firms, and monitoring and mitigating emerging systemic risks."

**Federal Reserve Board
Governor Daniel Tarullo⁴**

³ Banking Outlook 2014: An Industry at a Pivot Point, KPMG LLP, 2014.
<http://www.kpmg.com/us/en/industry/banking-capital-markets/pages/banking-2014-industry-at-pivotpoint.aspx>

⁴ Statement by Federal Reserve Board Governor Daniel K. Tarullo before the Committee on Banking, Housing, and Urban Affairs U.S. Senate Washington, D.C., February 6, 2014.

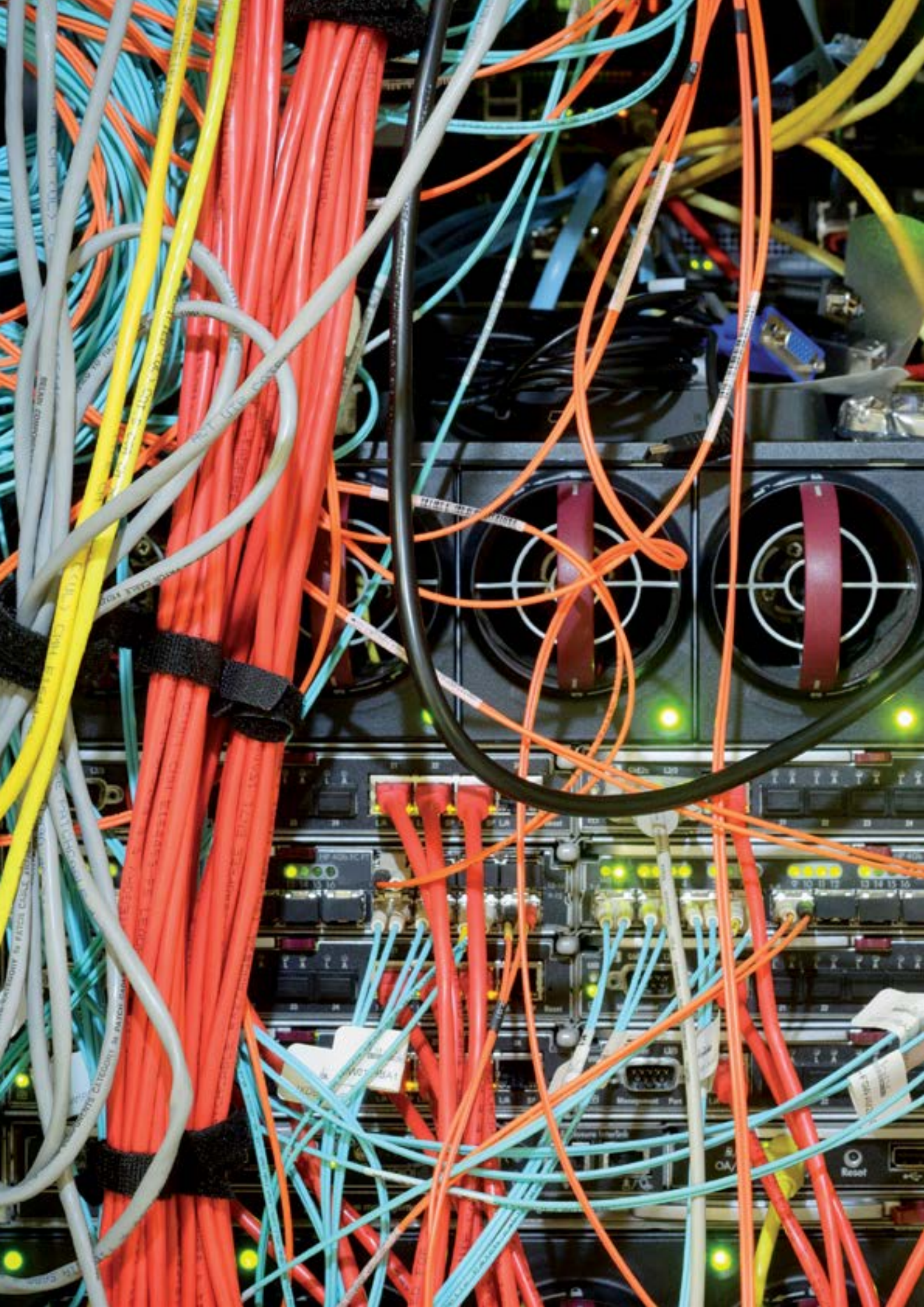
02 Strategic and Structural Change

Many still question whether or not the Dodd-Frank Act resolved "too big to fail."

One issue on the agenda of financial reform remains as thorny as ever: how to deal with banks regarded as "too big to fail." Following the financial crisis, the Dodd-Frank Act and the regulatory agencies charged with implementing it sought to reduce the size and complexity of the largest banks. Yet, politicians are keen to point out that the largest financial institutions in the U.S. have grown larger since the crisis. This, they argue, raises serious questions about systemic risk in the U.S. and whether the "too big to fail" question has been adequately addressed.

Whether or not policymakers will adopt additional measures to address "too big to fail" concerns is a question on the minds of many. The regulators, including Federal Reserve Chair Janet Yellen, have stated that the Dodd-Frank Act should be fully implemented before additional restrictions are considered. However, the possibility that further legislation to address these concerns could be adopted by the U.S. Congress should not be lightly dismissed.







Effects of Basel III and beyond

The Federal Reserve’s final rule implementing the Basel III capital framework took effect on January 1, 2014 and will lead to full implementation five years later.⁵ The strengthening of banks’ capital and liquidity positions has already led to far-reaching changes in the way financial institutions operate. But no sooner was the ink dry on the final rule than there emerged the prospect of a further tightening by regulators of capital and liquidity requirements. As KPMG has argued, Basel 4 may be emerging.⁶

The U.S. is requiring banks to meet minimum capital ratios even after the impact of severe stress events and is pushing for tougher liquidity standards and leverage ratios, more stringent than those required under Basel III. Litigation costs related to the

financial crisis are also being factored into the operational risk capital charge even when banks have exited the associated business or product offering. Regulators continue to voice concern about banks’ internal modeling and the accuracy of the resulting risk-weighted assets. Many have begun to call for a new emphasis on greater simplicity, new capital and liquidity requirements, and more disclosure:

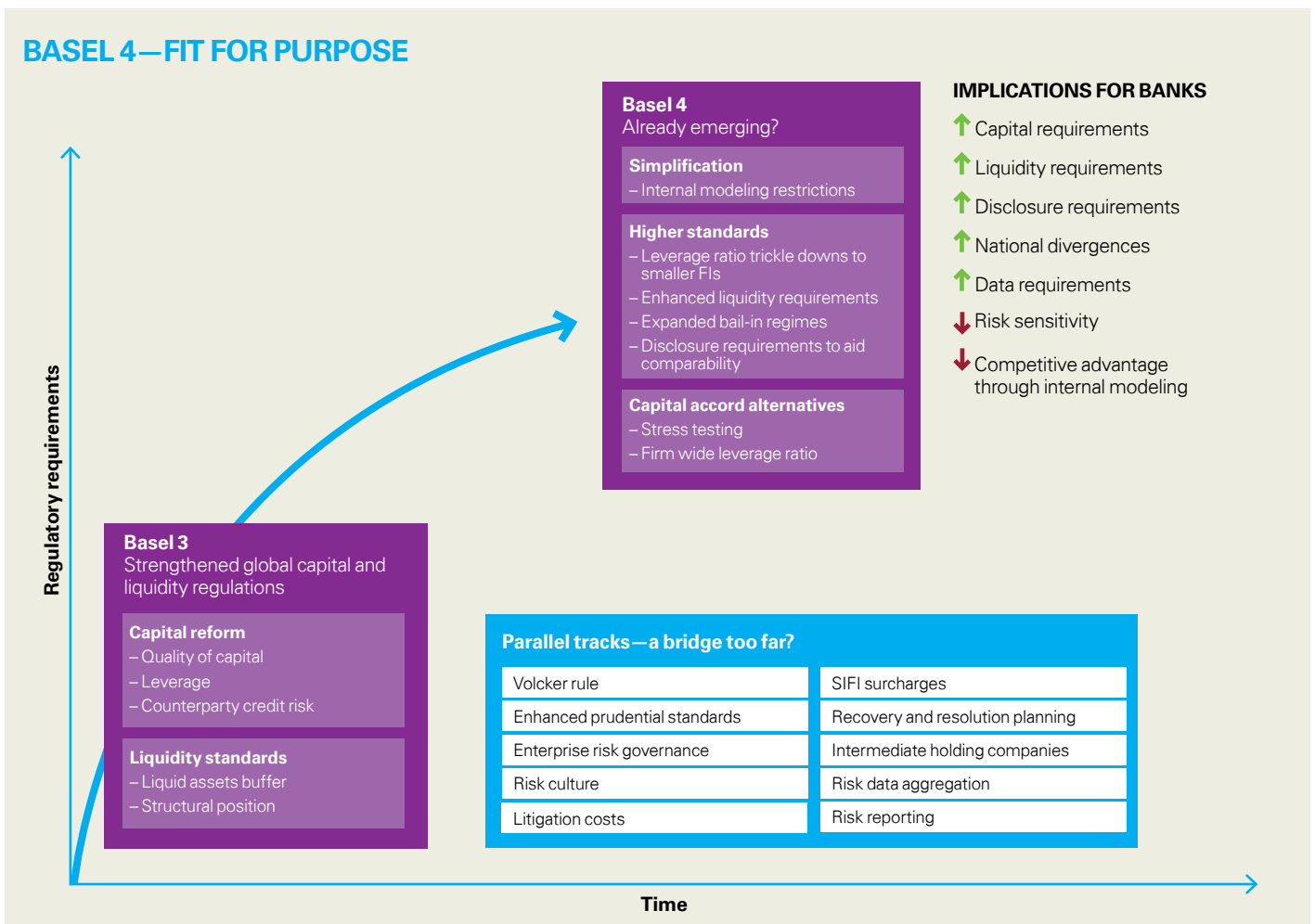
Higher capital requirements. Banks are likely to face a combination of a higher minimum-leverage ratio, restrictions on the use of internal models for risk weights, and a tougher regulatory approach to imposing stress test and Pillar 2 buffers above minimum capital requirements. This will require banks to hold more capital or to reduce their on- and off-balance-sheet activities.

Improved capital management. Banks will need to plan their capital requirements for supporting their operations and link this clearly to their strategy, risk appetite, and business models. This is the major focus of the CCAR exercise in 2014 and is a much stricter version of the Pillar 2 risk management and supervisory review process under the Basel regime.

Apart from regulations governing capital and liquidity requirements, the U.S. supervisory agencies have finalized rules restricting proprietary trading by banks and investments in hedge funds and private equity funds, the so-called Volcker Rule, a measure that lawmakers believed to be a key element in reducing systemic risk in the financial system when adopting the Dodd-Frank Act. Yet the final issuance of the regulation implementing the Volcker Rule has raised far more questions than it answered.

⁵ Regulatory Practice Letter 13-13, KPMG LLP, July 2013 <http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/regulatory-practice-letters/Pages/regulatory-practice-letter-13-13.aspx>

⁶ Basel 4 – Emerging from the mist? KPMG International, September 2013. <http://www.kpmg.com/global/en/issuesandinsights/articlespublications/regulatory-challenges/pages/emerging-from-the-mist.aspx>



Basel 4 – Emerging from the mist? KPMG, September 2013.

<http://www.kpmg.com/global/en/issuesandinsights/articlespublications/regulatory-challenges/pages/emerging-from-the-mist.aspx>



Final Volcker Rule Regulatory Practice Letter 13-21, KPMG LLP, December 2013.

<http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/regulatory-practice-letters/Pages/regulatory-practice-letter-13-21.aspx>



Volcker Rule

Section 619 of the Dodd-Frank Act states that “unless otherwise provided in this section, a banking entity shall not engage in proprietary trading; or acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.” What began with this clear-cut declaration has ballooned into a final regulation comprising 963 pages, agreed upon by five agencies: the Federal Reserve, FDIC, OCC, SEC, and CFTC.⁷ The conformance period runs from April 1, 2014 to July 21, 2015.

The aim is to prohibit banks from engaging in proprietary trading for their own gain, while not restricting market-making activities that banks take on behalf of their clients. Drawing the line between one kind of trading and another has proved extremely complicated and the rule has turned out to be one of the most controversial regulatory regimes to be introduced into the financial services industry.⁸ As Federal Reserve Governor Daniel Tarullo has explained: “A specific trade may be either permissible or impermissible depending on the context and circumstances within which the trade is made.”⁹

The Volcker Rule prohibits banks from engaging in short-term proprietary trading of securities, derivatives, commodity futures and options for their own account. But there are significant exceptions. U.S. banks are permitted to conduct proprietary trading of U.S. government, agency, state, and municipal obligations. It also permits, in more limited circumstances for foreign banking organizations, proprietary trading in foreign sovereign debt. Certain activities are also exempt, such as market making, underwriting, risk-mitigating hedging, and organizing and offering a hedge fund.

The rule requires banking entities to establish an internal compliance program to “help ensure and monitor compliance with the prohibitions and restrictions of the statute.” Additionally, the Chief Executive Officer (CEO) of a banking entity with significant activities must annually attest in writing to the relevant agency that the banking entity has in place a compliance program “reasonably designed” to achieve compliance with the final rule.

One underlying question remains whether the rule will have the effect of pushing riskier trading into unregulated instruments conducted by nonbanks, such as hedge funds, private equity funds and investment management companies. If the intention of the rule was to reduce bank risk then it may have achieved this, but by only pushing the risk into less heavily regulated parts of the financial system.

One market that was previously unregulated and is now highly regulated (under Title VII of the Dodd-Frank Act) is the over-the-counter swaps market, including trading in credit default swaps and credit derivatives, another area that lawmakers believed was one of the causes of the U.S. financial crisis. The shift from an over-the-counter structure to a market in which trades have to be cleared by central clearing houses has shifted the risk from banks to clearing houses (financial municipal utilities that have been deemed significant to financial stability) where the risks are supposedly easier to monitor and manage. In addition, further proprietary trading restrictions on affiliates, the so-called “push out” requirements are intended to complement the Volcker Rule and further reduce trading risk. Financial derivatives are now subject to new margin and reporting requirements that banks are struggling to meet. The clearing houses are also having difficulty establishing the required trading infrastructure within a short time frame.

The extent to which these new trading restrictions, coupled with increased capital, liquidity, and leverage requirements, will push risk out of the more heavily regulated banking system into less regulated areas remains an open question. It is an issue which policymakers are closely following and something that the Financial Stability Board (FSB) has long been concerned about. The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) and charged it with designating nonbank systemically important institutions, in addition to assuring financial stability. As of March 2014, the FSOC has designated three nonbanks as systemically important financial institutions in addition to eight others designated as systemically important financial market utilities. It remains to be seen whether the FSOC will be truly effective in its new role.

The extent to which these new trading restrictions, coupled with increased capital, liquidity, and leverage requirements, will push risk out of the more heavily regulated banking system into less regulated areas remains an open question.

⁷ Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC).

⁸ Regulatory Practice Letter 13-21, KPMG LLP, December 2013. <http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/regulatory-practice-letters/Pages/regulatory-practice-letter-13-21.aspx>

⁹ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a-tarullo-statement.htm>

03 Conduct and Culture

In many respects these failings may prove to be as important to banks and their regulation as the initial financial crisis. They have been a reputational catastrophe for both the banks involved and the wider banking sector.

The behavior of global banks is under renewed scrutiny, with regulatory authorities on both sides of the Atlantic investigating a possible conspiracy to manipulate foreign exchange rates, as well as possible misconduct in the swap, commodity and energy markets. There also have been a number of high-profile cases by the SEC, CFTC and the U.S. Department of Justice in addition to new fines waged against the industry on almost a daily basis.

The increasing number of fines related to misconduct and ongoing investigations have exposed not only misconduct but also weak risk cultures and inadequate governance controls. Everyone that works for a bank should now be forced to focus on compliance as never before. Many front-line employees will need extensive training to adjust to the new control environment. Banks in the U.S. should expect more scrutiny and further regulation in the area of wholesale conduct as investigations into trading practices continue, and they should immediately begin a training regime for their employees. Banks must ensure that their employees are “doing the right thing.” But they must also know when they are not.







Even though recent headlines have focused more on wholesale financial market misbehavior, the heavy fines in 2012 relating to anti-money laundering and the record-setting settlements related to mortgage foreclosure practices should not be overlooked. U.S. regulatory agencies have stressed the importance of responsible conduct in consumer banking for some time. Moreover, the Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB) to put consumer protection at the forefront of financial supervision and regulation. As such, renewed vigor is in place to help protect consumers from unfair, deceptive or abusive acts or practices and to enforce rules that prohibit unfair treatment in consumer finance. But prudential regulators, such as the OCC and the Federal Reserve, are also keeping a close eye on the way that banks serve their retail customers.

Examiners have shifted focus from evaluating whether a financial institution is in compliance to ascertaining whether and how it “assesses and mitigates consumer protection risk.”¹⁰ To this end, the CFPB is actively investigating consumer complaints, and this will likely play an increasingly important role in the supervisory and examination process. As defined by the Dodd-Frank Act, the CFPB has the power to impose significant penalties on both banks and nonbanks and it has used this new authority on a number of occasions to exact heavy fines on financial service providers.

The CFPB is focusing much of its attention on behavior that may be deemed to be an unfair, deceptive, or abusive act or practice (UDAAP). Based on pronouncements and enforcement actions to date, the CFPB is interpreting the UDAAP mandate quite broadly. For example, a potential violation that is not explicitly identified by the Equal Credit Opportunity Act (ECOA) may still fall under UDAAP.

More enforcement actions are expected around such issues as fair billing and fair lending. Now, customers such as students and the elderly are increasingly the focus of UDAAP protections. One way that banks are responding is to conduct a significant number of UDAAP risk assessments, including a review of add-on features across product types, credit card reward programs, third-party services, and associated customer treatment and billing.

Recent guidance issued by the CFPB around financial institutions’ compliance culture and conduct, calls on institutions to investigate whether they see ethical problems arise during the course of their business activities. Once a potential problem is spotted, financial institutions are expected to remediate it and immediately notify the CFPB. Financial services providers should not expect scrutiny to stop there, however. Financial institutions are meant to go beyond responsible lending standards and promote the personal accountability of employees working with customers by considering the “reasonable” value of products and services (the benefits versus the costs), while tracking individual conduct. Both regulators and banks are looking for key risk indicators that will measure the way that staff interact with customers, while also satisfying anti-money laundering and cybersecurity threats, in addition to monitoring consumer complaints.

The CFPB continues to arouse a great deal of trepidation within the industry. The stricter regulation of bank practices in the area of consumer finance is now a fact of life that banks must accept. For many, this is leading to far-reaching changes and is causing banks to move from a product-centric business model to a customer-centric model. This will not be a smooth transition, but the more successful institutions are likely to be those that move now rather than being forced to do so later.

Banks must ensure that their employees are “doing the right thing.” But they must also know when they are not.

The stricter regulation of bank practices in the area of consumer finance is now a fact of life that banks must accept. For many, this is leading to far-reaching changes and is causing banks to move from a product-centric business model to a customer-centric model.

Everyone that works for a bank should now be forced to focus on compliance as never before. Many front line employees will need extensive training to adjust to the new control environment.

¹⁰ Navigating the Consumer Financial Protection Bureau, KPMG LLP, 2013. <http://www.kpmg.com/US/en/services/Advisory/risk-and-compliance/financial-risk-management/Documents/navigating-the-consumer-financial-protection-bureau.pdf>



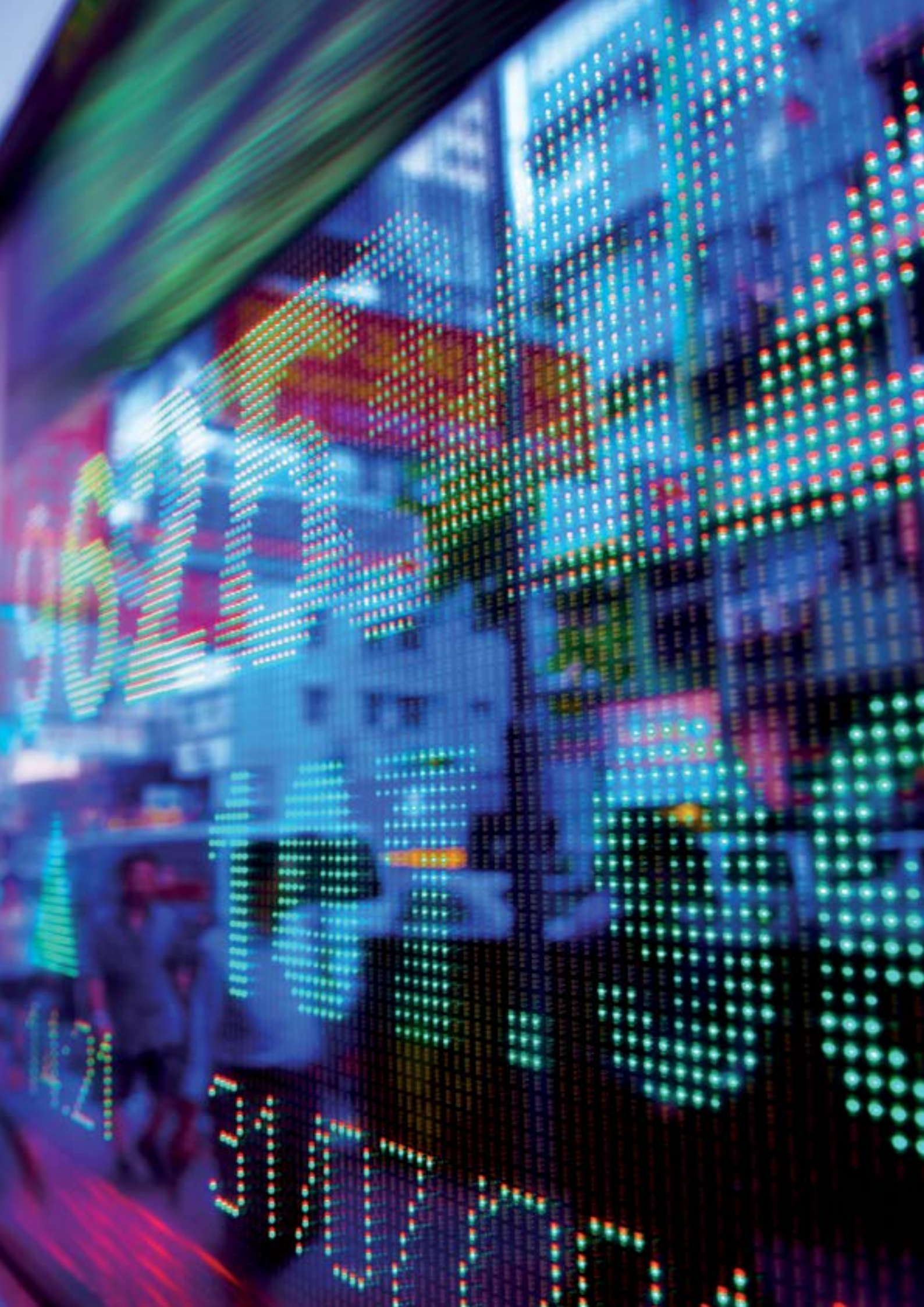
04 Data and Reporting Aggregation

The financial crisis revealed the inadequacy of banks' risk data systems and processes, impeding the ability both of banks to manage risk and of regulators to maintain liquidity and limit contagion.

Regulators are now seeking to instill more effective practices in the management of data, and banks need to review and improve their data management infrastructure. It is an expensive undertaking, but the benefits, in the long run, will almost certainly outweigh the costs of failing to take action.

Over the years, management systems in banks have had to cope with new regulatory reporting requirements, new corporate structures, novel products, and altered operating models. Despite the big changes in the industry, the systems for the collection, aggregation and analysis of risk data have developed incrementally, by adding on different modules and cobbling together incompatible data sets, and a range of ad hoc processes. In many cases, these systems have become so unwieldy and unstable that they are failing in their core purpose.

Relevant data is missing or inadequately analyzed, often resulting in the formation of "reconciliation industries" within the organization as data is passed from one system to another across inconsistent integration mechanisms. The extent to which these reconciliation industries have evolved within organizations is often underestimated and rarely quantified in terms of productivity loss. Risk data is being provided to management too late to influence critical decision making. Responsible management and control functions are both compromised while operating costs are inflated.



DATA AND REPORTING AGGREGATION

Closer regulatory attention

Regulators have become increasingly concerned about the implications of the industry's weak and inadequate risk data and aggregation systems. The industry's shortcomings were exposed at the height of the financial crisis when regulators asked for up-to-date assessments of risk and exposures and many institutions were unable to provide the data required, or found themselves coordinating a massive ad hoc project to assemble the data demanded by their management teams and by regulators. Major market participants could not extract

the necessary information quickly enough to understand the location and extent of risks and exposures. This was one significant cause of the collapse of confidence in the global financial system.

In response, regulators are now focusing not only on the risk assessment process, but on the quality of the underlying data and the infrastructure to support risk aggregation across a firm. In 2009, the Basel Committee on Banking Supervision (BCBS) issued guidance designed to enhance banks' ability to identify and manage bankwide risks;¹¹ and in 2013 the BCBS published a set of principles to strengthen risk data aggregation

capabilities and internal risk reporting practices, along with guidance on their implementation.¹²

The principles, which provide qualitative and quantitative measures, cover four main areas:

- The importance of boards of directors and senior management exercising strong governance over a bank's risk data aggregation capabilities, risk reporting practices and IT capabilities
- The accuracy, integrity, completeness, timeliness and adaptability of aggregated risk data

¹¹ Basel Committee on Banking Supervision, Enhancements to the Basel II framework, BCBS158, www.bis.org/pub/bcbs158.pdf, July 2009

¹² Basel Committee on Banking Supervision, Principles for effective risk data aggregation and risk reporting, BCBS239, www.bis.org/pub/bcbs239.pdf, January 2013

EXPONENTIAL INCREASE IN REGULATORY REPORTING REQUIREMENTS

RECOVERY AND RESOLUTION PLANNING

Banks are having to provide very detailed information on recovery plans and to assist resolution planning by the authorities.

MARKET DISCLOSURES

Enhanced 'Pillar 3' disclosures by banks, including standard templates and greater transparency on internal model-based approaches.

MACRO-PRUDENTIAL OVERSIGHT

National, regional and international macro-prudential authorities are increasing rapidly their collection of systemwide data, including on interconnectedness within the banking system, and the role of banks in securities financing transactions and in funding the shadow banking sector.

STRESS TESTING

Regulators will be assessing whether banks' data architectures and IT infrastructures can support ongoing stress-testing and new reporting requirements.

INCREASE IN REGULATORY REPORTING REQUIREMENTS

BANK SECRECY ACT/ANTI-MONEY LAUNDERING AND TAX

Although the details differ, there are growing data and reporting demands on customer due diligence, customer classification, and the reporting of specific information to various authorities.

INDIVIDUAL NATIONAL SUPERVISORS

Multiplicity of detailed national reporting requirements introduced since the financial crisis.

METRICS REPORTING

Banks engaged in significant trading activities will have to document their compliance with the Volcker Rule through improved recordkeeping and reporting.

Source: Adapted from *Evolving Banking Regulation*, EMA Edition, KPMG International, February 2014



- The comprehensiveness, accuracy, clarity, usefulness, frequency and distribution of risk management reports, including board of director and senior management reports
- The need for supervisors to review and evaluate a bank's compliance with the first three sets of principles listed above, to take remedial action as necessary, and to cooperate with both domestic and international bank supervisors.¹³

Regulators are now seeking to instill more effective practices in the management of data, and banks need to review and improve their data management infrastructure. It is an expensive undertaking, but the benefits, in the long run, will almost certainly outweigh the costs of failing to take action.

A successful transformation of risk data aggregation and management requires a considerable investment of time and resources. A thorough renovation of the risk IT personnel and infrastructure is a strategic investment that is likely to satisfy regulatory demands and lead to competitive advantage.

Key issues

Where banks have undertaken systematic analysis and testing of their current processes, the results have often been worrying. In certain cases, it has revealed that compiling a comprehensive groupwide set of risk exposures has taken up to 60 days. The larger and more complex a bank, the more likely it is that risk data is incomplete, inadequate, or out-of-date, particularly on an aggregated and global level. Banks may have all of the information, but it's often inefficiently stored, inconsistently formatted, poorly integrated, and difficult to analyze. Senior management should be aware of the risk of flying blind, especially in extreme events, and of making and implementing decisions in the absence of reliable risk metrics. It is critical, therefore, that financial services companies review the strength and effectiveness of their risk data architecture and systems.

There are four key issues that need to be addressed:

Efficiency. Data often resides in different silos, owned by different functions (such as trading desks, market groups, risk control, finance, or back-office), all with different approaches and incentives to data

management, not to mention governance structures. With multiple systems and incompatible data, risk professionals often spend too much time on data aggregation and reconciliation and too little time on the real analysis needed for risk management and strategic decision making.

Flexibility. It is important to be able to react quickly to market events in terms of preparing scenario analyses and reports that are not contained in standard operating procedures. It is also necessary to have the flexibility to react rapidly to regulators' requests for reports and data without an immense amount of manual work.

Quality. Since banks tend to have multiple, discrete systems, the quality of data is degraded by incompatible definitions, inconsistency, incompleteness, and duplication. Very often, data cleansing is only partially successful. With poor quality data, risk management can become ineffective.

Governance. Too often, ownership of risk data is shuffled between the control function and the IT function, with senior management taking little direct responsibility. Without a clear structure of governance and ownership, there is no accountability and no commitment to quality.

¹³ For further information see KPMG's Regulatory Practice Letter 14-01: BCBS Issues Bank Progress Report on Effective Risk Data Aggregation and Risk Reporting. <http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/regulatory-practice-letters/Pages/regulatory-practice-letter-14-01.aspx>

DATA AND REPORTING AGGREGATION

Improvements and potential benefits

Banks are likely to benefit greatly by improving overall data quality and establishing effective risk data aggregation processes, thereby enabling more effective analysis of underlying risk. The ability to consolidate and synchronize all relevant risk data can lay the foundation for a more comprehensive and consistent analysis, enabling better business management, better risk management and improved operating models. Leading banks appreciate the potential gains and are working to strengthen the contribution of effective risk data and aggregation management to their overall business and corporate strategy.

High-quality and quality-assured risk data should lead to improved decision making, greater confidence, and a more

stable strategy. With greater confidence in data validity, risk IT architecture can be streamlined, leading to efficiencies in both routine operations and in maintenance and development. In turn, these benefits offer improved ability to respond quickly and effectively to changes in corporate strategy, operating environment or—indeed—regulatory demands. If regulators have greater confidence in a bank’s risk data and the aggregation infrastructure underlying it, the whole regulatory compliance system can be streamlined and perhaps be less challenging. In some cases, improved data aggregation can bring direct economic benefits and reduced capital requirements. Currently, for example, a significant proportion of a bank’s collateral contracts are not captured effectively, and so cannot contribute to risk-weighted capital

calculations. More comprehensive and accurate data aggregation methodology can bring this into the equation.

A successful transformation of risk data aggregation and management requires a considerable investment of time and resources. Skills in the field are in short supply, and senior management of banks may seem reluctant to make further investments when so much money has already been poured into upgrading systems and processes. But above all, banks must make fundamental changes in the way core functions operate, even if it entails a complete overhaul of the organization and its processes. A thorough renovation of the risk IT personnel and infrastructure is a strategic investment that is likely to satisfy regulatory demands and lead to competitive advantage.

RISK DATA AGGREGATION AND REPORTING: FROM PRINCIPLES TO ACTIONS



The principles translate into four key areas of impact

- 1 Governance
- 2 Data architecture and IT infrastructure
- 3 Accuracy and Integrity
- 4 Completeness
- 5 Timeliness
- 6 Adaptability
- 7 Accuracy
- 8 Comprehensiveness
- 9 Clarity and usefulness
- 10 Frequency
- 11 Distribution
- 12 Review
- 13 Remedial actions and supervisory measures
- 14 Home/host cooperation

IT ARCHITECTURE

- Risk data models unified or automatically reconcilable across banking group with unified naming conventions
- Unified level of detail of data across the group to enable fully flexible reporting
- Risk and accounting data to be reconciled
- High degree of automation for risk data aggregation
- Single source of risk data for each risk type

DATA QUALITY FRAMEWORK

- Effective data quality management including automated measurement methods and escalation procedures
- Comprehensive data governance for risk data including data owners from business and IT
- Documentation of reporting and reconciliation processes
- Automatic and manual quality checks in the reporting process

RISK REPORTING

- Adaptable and ad hoc reporting capability with drill-down into various risk dimensions, stress testing
- Comprehensive, timely, dependable and adaptable risk reporting capability across all units and all material risks

ORGANIZATIONAL AND IT MANAGEMENT

- Risk reporting and aggregation to be mapped into IT strategy/implementation roadmap
- Independent validation of standard compliance
- Full business continuity capability for risk reporting

Source: Adapted from Evolving Banking Regulation, EMA Edition, KPMG International, February 2014



'Risk comes from not knowing what you are doing.'

Warren Buffett

05 Risk and Governance

Fundamental change is required across all aspects of risk governance. Large banks need to reassess how they govern themselves, starting with their risk culture and covering the entire risk management process across the enterprise.

Since 2008, the prudential regulators at the Federal Reserve, the OCC and the FDIC have placed renewed emphasis on the importance of basic risk governance, stress testing and the capital planning process. They have directly focused, publicly and privately, on the need for larger banks to reassess how they govern themselves, starting with their risk culture and covering the entire risk management process across the enterprise.

Both the Federal Reserve and the OCC have issued new rules to improve the resiliency of banks' operations. In February 2014, the Federal Reserve approved a final rule establishing enhanced prudential standards for large U.S. bank holding companies. It also requires foreign banks with a significant U.S. presence (above \$50 billion in U.S. assets) to establish an intermediate holding company over its U.S. subsidiaries. When adopting the Final Rule, Federal Reserve Chair Janet Yellen said, "As the financial crisis demonstrated, the sudden failure or near failure of large financial institutions can have destabilizing effects on the financial system and harm the broader economy. And, as the crisis also highlighted, the traditional framework for supervising and regulating major financial institutions and assessing risks contained material weaknesses. The Final Rule addresses these sources of vulnerability."¹⁴

¹⁴ <http://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm>





NEW THIRD-PARTY OVERSIGHT FRAMEWORK

The regulatory agencies have also increased their focus of banks' third-party risk management processes.¹⁶ The growth in outsourcing activities has increased since the crisis as firms have focused on cost savings to offset revenue declines; however, internal oversight programs have not kept pace. This increases the risk to the firm and the financial system as a whole as more critical functions are outsourced. Recent guidance from the OCC and the Federal Reserve outlines enhanced examination procedures in this area, and reflects the evolution in regulatory thinking about how firms must manage the third-party oversight process. Banks should begin to assess their monitoring and management of third-party compliance risk, with special attention to those functions that touch consumers. In particular, banks should be able to demonstrate that they are conducting effective and consistent risk assessments, ensuring effective challenge from the second and third lines of defense, and effectively reporting third-party risk to their boards of directors. The guidance is a wake-up call to alert institutions to the critical importance of third-party management as part of their enterprise risk and compliance assessment.

For large U.S. bank holding companies, the final rule incorporates the previously issued capital planning and stress testing requirements as an enhanced prudential standard. It also requires a U.S. bank holding company to comply with enhanced risk management and liquidity risk management standards. Banks must in addition conduct liquidity stress tests and hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event. The Federal Reserve argues that these new requirements will help ensure that firms continue to lend in times of financial stress.

Furthermore, the final rule requires publicly traded U.S. bank holding companies with total consolidated assets of \$10 billion or more to establish enterprise-wide risk committees. The new requirements for U.S. bank holding companies complement the stress testing and resolution planning

requirements for large bank holding companies that the banking agencies previously finalized.

The OCC, for its part, has developed a set of heightened expectations to improve its supervision of banks and strengthen the risk management practices of the largest U.S. financial institutions. In January 2014, the OCC proposed a set of enforceable risk governance guidelines¹⁵ for national banks with more than \$50 billion in total assets. These would set higher standards for risk governance frameworks and oversight by board of directors.

The regulators will likely continue to raise their expectations regarding the way banks manage risk, based on their observation of trends in the industry. Since the crisis, the regulators have increasingly employed the use of horizontal examinations to better gauge industry practice across institutions with common risk characteristics. Indeed,

¹⁵ <http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-4a.pdf>

¹⁶ The New Third Party Oversight Framework, KPMG LLP, February 2014 <http://www.kpmg.com/US/en/services/Advisory/risk-and-compliance/financial-risk-management/Documents/the-new-third-party-oversight-framework-brochure.pdf>

RISK APPETITE FRAMEWORK

The FSB's Principles for an effective risk appetite framework recognize that the concept of risk appetite was not always well understood, quantified or embedded in business management. The Principles state that the framework should:

- Be driven by both Board leadership and the involvement of management at all levels;
- Be communicated, embedded and understood across the bank, including being embedded into the bank's risk culture;
- Act as a brake against excessive risk-taking;
- Allow for the risk appetite statement to be used as a tool to promote robust discussions of risk and as a basis upon which the Board, risk management and internal audit functions can effectively and credibly debate and challenge management recommendations and decisions;
- Cover subsidiaries and third party outsourcing suppliers that may be outside the direct control of the bank; and
- Be adaptable to changing business and market conditions.

The FSB defines the three key elements of an effective risk appetite framework as follows:

→ A risk appetite statement that:

- Is linked to the bank's short- and long-term strategic, capital and financial plans;
- Establishes the amount of risk the bank is prepared to accept in pursuit of its strategic objectives and business plan, taking into account the interests of its depositors and shareholders as well as capital and other regulatory requirements;
- Determines for each material risk the maximum level of risk that the bank is willing to operate within, based on its risk appetite, risk capacity, and risk profile;
- Includes quantitative measures that can be translated into risk limits applicable to business lines, legal entities and groups;
- Includes qualitative statements for risks that are not easy to measure, including reputational and financial consequences of poor management of conduct risks across retail and wholesale markets;
- Ensures that the strategy and risk limits of each business line and legal entity align with the bank-wide risk appetite statement; and

- Is forward looking and subject to scenario and stress testing to ensure that the bank understands what events might push the bank outside its risk appetite and/or risk capacity.

→ Risk limits that interact with the risk appetite because they:

- Constrain risk-taking within risk appetite;
- Are established for business lines and legal entities, and include material risk concentrations at the firm-wide, business line and legal entity levels (e.g. counterparty, industry, country/region, collateral type, product);
- Do not default to regulatory limits, and are not overly complicated, ambiguous, or subjective; and
- Are monitored regularly.

→ A set of supporting roles and responsibilities – the Principles include detailed job descriptions that outline the roles and responsibilities of the Board and senior management with respect to the risk appetite framework.



that was the focus of the first stress test conducted by the Federal Reserve in 2009, in addition to determining the capital adequacy of the U.S. banking system. That first stress test, known as the Supervisory Capital Adequacy Process (SCAP), became the model for the later CCAR exercises.

In many ways the focus on horizontal examinations provide financial institutions with an opportunity to benchmark themselves against the industry leaders to identify emerging best practices. While it allows banks and supervisors to compare the range of practices in the industry, it also enables regulators to raise the bar for risk governance throughout industry.

Banks will have to do a better job in the future to show how risk management and governance work closely together to develop overall business strategy. In particular, banks have to show, and clearly document, how strategic planning is linked to the formulation of their risk appetite.¹⁷ The tools to report on risk, however, may not be robust enough, and, in fact, a number of banks are overhauling their technology platforms for governance, risk, and compliance (as noted in the previous

section of this report). This should enable them to monitor risks more effectively across the enterprise and to link the risk assessment with the risk appetite statement. The key, however, is integration into the strategic planning process.

Another way in which banks need to show regulators they are doing a better job managing risk is in clarifying the roles and responsibilities of the three lines of defense. Before the crisis, the first line of defense was largely operational in name only. Business lines often pushed back against management mandates to institute control processes, arguing that precious time and resources were not being used effectively. Moreover, first lines were not properly incented to control risk. As long as revenue was strong, the status quo was likely not questioned. The crisis put that to rest, and while everyone now agrees that this dynamic must change, most banks are struggling with how to instill stronger control functions at the business line level.

At many financial institutions, the demarcation between the first and second lines is undergoing a fundamental review. This is especially the case in the management of operational risk as many

“As the financial crisis demonstrated, the sudden failure or near failure of large financial institutions can have destabilizing effects on the financial system and harm the broader economy. And, as the crisis also highlighted, the traditional framework for supervising and regulating major financial institutions and assessing risks contained material weaknesses.”

**Federal Reserve Board
Chair Janet Yellen**

¹⁷ Developing a Strong Risk Appetite Program, KPMG International, November 2013. <https://www.kpmg.com/global/en/issuesandinsights/articlespublications/pages/risk-appetite.aspx>

SOUND RISK GOVERNANCE PRACTICES

A thematic review undertaken by the FSB of 36 banking groups across the G20 area showed that these firms had made improvements since the financial crisis in risk governance, not least in:

- Assessing the collective skills and experience of the Board;
- Undertaking more frequent and more demanding Board effectiveness reviews;
- Instituting a stand-alone risk committee; and
- Establishing a group-wide CRO.

However, these groups had made less progress in:

- Establishing and implementing a clear risk appetite statement;
- Defining the responsibilities of the risk committee and its interactions with the audit committee; and
- Strengthening risk management functions, in particular IT infrastructure and the ability to aggregate risk data efficiently and

effectively. The review drew a clear link here to the Basel Committee principles on risk data aggregation and reporting.

The FSB used examples of good practice to develop a set of sound risk governance practices for banks to aspire to, and for national authorities to use as a basis for assessing risk governance in major financial institutions. The FSB also recommended that international standard setters and national authorities should adopt more consistent approaches and should toughen their standards to reflect these sound risk governance practices.

The sound risk governance practices identified by the FSB include:

- The independence and expertise of the Board;
- The role of the Board in establishing and embedding an appropriate risk culture throughout the firm;

- The membership and terms of reference of the risk and audit committees;
- The reporting lines of the CRO (direct to the CEO, not through the CFO) and a distinct role from other executive functions and business line responsibilities;
- The importance of CRO involvement in all significant group-wide risks (including treasury and funding) and in key decision-making processes from a risk perspective (including strategic planning, mergers and acquisitions);
- The independence, authority and scope of the risk management function; and
- The independent assessment of the risk governance framework, including both an enhanced role for internal audit and the use of external third parties.

The review found significant gaps in all the banking groups in its sample, so banks should not assume that they are performing well against these criteria.



of the recent operational risk failures (think foreclosure processing) were frontline issues.

This has raised a number of questions about the role of the second line of defense, for regulators and the industry alike. The prudential regulators understand that large banks are complex organizations but they expect banks to demonstrate through adequate documentation that the first line is doing its job and is accountable. They also expect to see skilled people to manage the second line of defense (risk management) and the third (internal audit). The supervisors are focusing on this more tightly and are now quicker to criticize banks in this area than ever before.

The regulators are also expecting banks to establish effective procedures for risk managers to challenge not only specific business decisions but the entire governance process, including whether the risk culture has been communicated and consistently upheld. Right now, most banks lack procedures for doing so, although most large banks have maintained a Chief Risk Officer (CRO) office for some time. It is the integration with the first line that is missing, which is often through the door of the Chief Financial Officer (CFO).

Some banks have considered an office dedicated to taking an enterprise-level approach to ensure that all functions are doing what is expected of them and are working together well to manage risk. Such an office would manage the bank's entire risk governance program and would assess whether each department is doing what is needed to manage risk. It would report independently to the CRO and the Board Risk Committee.

Other banks are considering the development of a risk vision statement that would be the equivalent for risk of a corporate mission statement. This is in addition to the risk appetite statement approved by the board of directors. A risk vision statement would describe the risk culture the bank is aiming for, as well as its risk appetite, the operational structure of its three lines of defense, and the role of the risk committee. The risk vision would articulate how the bank ensures its personnel are doing the right things and how it will know when they are not.

The regulators will continue to raise their expectations regarding the way banks manage risk, based on their observation of trends in the industry.

Banks need to undertake transformational change to their basic cultural identity and implement significant improvement to their overall risk management and governance structure.





06 Canada



The U.S. Federal Reserve's long-awaited final rule establishing enhanced prudential standards for foreign banking organizations (FBOs) and U.S. bank holding companies is likely to have a sizeable effect on Canada's banks. Three of the six largest Canadian banks, which have U.S. nonbranch assets of \$50 billion or more, are expected to have to establish a U.S. intermediate holding company over their U.S. subsidiaries. This is a sizeable proportion of the 20 FBOs that Federal Reserve staff estimate will be subject to the IHC requirement. Due to the closely integrated nature of the Canadian and U.S. financial markets, the other three Canadian banks will also be affected in various ways by the final rule (as they have by the Dodd-Frank Act in general).

Canadian banks have been preparing for the Federal Reserve's final rule for some time, but even so, the publication of the rule is likely to lead to further changes in the structure of their U.S. holdings, especially when combined with the finalization of the Volcker Rule on proprietary trading of securities. The banks will likely be reviewing their U.S. business strategies and governance structures, as the requirements of Federal Reserve's final rule affect boards of directors, risk committees and chief risk officers. They will likely also be assessing

whether their current data systems can support the new stress testing requirements under the final rule and the metrics reporting required by the Volcker Rule starting in mid-2014. In addition, banks will likely be looking at the potential tax implications of restructuring their U.S. holdings and groupwide recovery and resolution plans may need to be adjusted also.

The final rule will also trap capital and liquidity in the banks' U.S. operations, thus causing the Canadian consolidated entity to hold capital levels considerably higher than those dictated by Basel III. Aside from the U.S. requirements, the six largest banks in Canada have been designated as domestic systemically important banks by the Basel Committee and will have to hold an additional one percent of capital by January 2016. They will also be subject to more intense supervision and enhanced disclosure requirements. These hurdles, however, do not appear to be insurmountable. Canada's banks are among the best capitalized banks in the world in terms of both the quality and quantity of capital, and have been judged the soundest in the world for six years running by the World Economic Forum in Switzerland.

From a business standpoint, Canadian banks continue to be highly profitable by international standards. The ROE of the six largest exceeded 17 percent as of

September 2013. Three of the banks are pushing further into the U.S. banking market and one is expanding in Latin America. They are not complacent, however, given the fact that Canada's regulators are strengthening their supervision in a number of ways, while compliance with new banking rules promulgated in Basel and Washington remain a high priority. In Canada, the Office of the Superintendent of Financial Institutions (OSFI) finalized rules in 2013 that tighten its governance guidelines for banks. The guidelines focus on the role of the board of directors, risk governance, and the role of the audit committee. (Banks will be evaluating whether their governance structures will need to adapt further to fit the Federal Reserve's new requirements.) The OSFI's focus in 2014 is on continued strengthening of risk management practices including operational risk and controls and the evolving role of internal audit. Other rules expected in 2014 include market conduct, and the fair treatment of customers (from the Financial Consumer Agency of Canada) and regulations on anti-money laundering. All in all, Canadian banks are in a strong position to cope with the next round of financial reforms both domestic and international.

07 Latin America



In Latin America, central banks and regulators have come under less pressure than their counterparts in the U.S. to make big changes in the rules governing banks and in the structure and processes of financial institutions. Even so, all the major countries in the region are adopting Basel III principles for capital and liquidity. And the three largest ones, Brazil, Mexico and Argentina have declared their commitment to maintain regulatory standards that are consistent with other members of the Group of Twenty largest economies (G20). In the case of Brazil and Mexico this has meant progressing in the development and implementation of regulations on banking issues that are important to the G20, such as risk governance, market conduct, fair treatment of customers, and anti-money laundering. Most of these regulations are already deployed or in the process of being deployed.

Argentina is placing a higher priority on regaining economic stability than on putting into effect these types of regulatory reforms. Of the big three, it was considered by the BCBS to be the least prepared in terms of adopting Basel rules. The Argentine government is trying to keep a lid on inflation and has attempted to control the (falling) exchange rate of the peso by various measures. These include limiting the amount of dollars Argentines can buy and implementing a program under which Argentines who brought undeclared offshore assets in to the country were exempt from liability for the tax due on historic gains.

In many other Latin American countries, particularly Chile, Peru, and Columbia, most large banks have been able to expand their balance sheets, thanks to strong consumer demand for financial products. Their capital ratios have continued to exceed the minimum capital requirements stipulated by the regulations, but, in the medium term, banks

are expected to have to change their capital mix and/or raise new capital to strengthen their position as a result of the continuing opportunities to increase balance sheets and the more stringent requirements of Basel III. A more challenging task in the short term is compliance with other regulations, both those that are aligned with the international agenda, such as governance, anti-money laundering (AML), anti-bribery and corruption, and treating customers fairly (TCF) in addition to those rules that are more specific to the region.

The focus of management, directors, and regulators on bank governance has been increasing since the end of the financial crisis when the benefits of sound risk management were highlighted and investors began to demand more transparency in the internal workings of the banks they trusted their money to. This has been given further prominence, particularly for listed banks, with the focus on sustainability and the creation of stock market indices that consider corporate governance as one of the most important factors for investors. This is evident in Brazil where, in general, any significant regulation that requires a bank to report to the central bank also requires that a director is held responsible for that area of the bank's operations.

AML has been emphasized in the bank reviews conducted by the central banks of Brazil and Mexico following the issuance of further guidance on reportable events at the end of 2012. Other countries in the region, such as Chile, have followed suit. Another regional trend in which Brazil has seen progress is a new anti-corruption law that affects all industries, not just banking, which came into force in 2013, and further detailed regulation is anticipated in 2014. Mexico took a similar step against corruption in 2012.

In terms of TCF, the Mexican government has also issued new regulations relating to the consumer sales practices of banks and it has reinvigorated the Consumer Protection Agency, which has begun to take a more active role in policing the banking sector. In Brazil, the central bank has issued regulations which aim to make it easier for clients to refinance their debts at a second bank, increasing competition and reducing costs to the client. In Chile, the government has lowered the interest rate cap that banks can charge on small loans.

As well as the changes imposed by Latin American regulators, local subsidiaries of foreign banks are coming under pressure to follow the same regulations as their parents in Europe and the U.S. The fact that foreign banks play a very sizeable role in the Mexican financial system (five of the top 10 banks in Mexico are foreign) may provide a business opportunity for domestic banks that face somewhat less tight regulations, or it could prove to be a selling point for the foreign banks and protect them from future fines, penalties, and legal losses.

Overall, banks in Latin America continue to enjoy ROE of 15–20 percent, among the highest levels in the world. This, coupled with the fact that the regulatory environment in most Latin American countries is regarded as solid, is likely to mean that raising capital will not prove to be too big a challenge for the region's banks. However, as economic growth has slowed, financial institutions in the region are expected to focus somewhat less on revenue growth and more on cost containment. They will likely aim to improve the efficiency of their branches and may invest more than before in technology that may ultimately save costs. A recent spate of bank mergers and acquisitions in the region is also likely to lead to greater efficiency.

08 Conclusion

Banks in the U.S. may believe they are in a seemingly impossible bind. Their compliance costs rise ever higher, but they feel constrained by the plethora of new regulations from expanding revenue rapidly enough to cover those costs. We believe there is a way out of this impasse that promises to satisfy the regulators while offering the prospect of higher profits. One strategy to achieve this is to place the customer at the heart of the bank's business and to innovate in such a way as to align compliance, cost, and the consumer experience.¹⁸

The key is to focus on innovations that will enable banks to better understand their customers' needs. For retail financial institutions, this might entail an analysis of social media sentiment, crowdsourcing, and the bank's ability to execute at the moment of decision making by the customer. Some banks are using advanced data modeling to predict how best to serve customers and control business risks. Another method is to use online issue tracking systems to monitor such things as mortgage applications and customer complaints. This provides banks with immediate information and the opportunity to escalate when necessary, thereby improving customer satisfaction while providing an audit trail to improve compliance with consumer conduct regulations.

Banks frequently talk about putting the customer first, but few actually transform their operations to the point where customer service drives the business. This would entail a complete overhaul of the bank's processes, technology, and culture. But financial institutions will have to do this anyway to continue functioning in the new regulatory normal. Better still to do so with the aim of generating revenue and goodwill, as well as effective compliance.

There is much to do, and most banks are still grappling with how to deal with the challenge. However, let there be no doubt, those that take action now should be ahead of the pack, and those that wait may find themselves in the backwater of a very large wake. Banks need to undertake transformational change to their basic cultural identity and implement significant improvement to their overall risk management and governance structure. There is no time to waste.

¹⁸ Aligning Compliance, Cost and the Customer Experience, KPMG in Canada, November 2013 <http://www.kpmg.com/ca/en/issuesandinsights/articlespublications/pages/aligning-compliance-cost-and-the-customer-experience.aspx>

Abbreviations

AML	Anti-Money Laundering
BCBS	Basel Committee on Bank Supervision
BHC	Bank Holding Company
CCAR	Comprehensive Capital Analysis and Review
CFTC	Commodity Futures Trading Commission
CFPB	Consumer Financial Protection Bureau
ECOA	Equal Credit Opportunity Act
FBO	Foreign Banking Organization
FDIC	Federal Deposit Insurance Corporation
FFI	Foreign Financial Institution
G20	Group of Twenty Largest Economies
G-SIB	Globally Systemically Important Bank
G-SIFI	Globally Systemically Important Financial Institution
IHC	Intermediate Holding Company
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank Offered Rate
OCC	Office of the Comptroller of the Currency
OTC	Over-The-Counter
RRP	Recovery Resolution Planning
SEC	Securities and Exchange Commission
TCF	Treating Customers Fairly
UDAAP	Unfair, Abusive, Deceptive Act or Practice

Acknowledgements

The Americas' FS Regulatory Center of Excellence would like to acknowledge the contribution of our colleagues from across KPMG's Americas' region and global network of firms, who helped develop this report:

Editorial Team

Brian Stephens
National Sector Leader,
Banking and Capital Markets
KPMG in the U.S.
T: +1 312-665-2154
E: bbstephens@kpmg.com

John Ivanoski
Partner and National Leader of KPMG's
U.S. Financial Services Regulatory
Practice
T: +1 212-954-2484
KPMG in the U.S.
E: jivanoski@kpmg.com

Pam Martin
Managing Director, Financial Services
Regulatory Center of Excellence,
Americas' Region
KPMG in the U.S.
T: +1 202-533-3070
E: pamelamartin@kpmg.com

Jim Low
Partner, Financial Services Audit
KPMG in the U.S.
T: +1 212-872-3205
E: jhlow@kpmg.com

Hugh Kelly
Principal and National Lead,
Bank Regulatory Advisory
KPMG in the U.S.
T: +1 202-533-5200
E: hckelly@kpmg.com

Contributors

Ricardo Anhesini
Partner, Head of Financial Services
Latin America and Brazil
KPMG in Brazil
T: +551121833141
E: rsouza@kpmg.com.br

Philip Aquilino
Managing Director
KPMG in the U.S.
T: +1 703-286-8029
E: paquilino@kpmg.com

Caryn Bocchino
Senior Manager, Financial Services
Regulatory Center of Excellence,
Americas' Region
KPMG in the U.S.
T: +1 203-406-8586
E: cbocchino@kpmg.com

Mary Filippelli
National Industry Leader – Financial
Services and National Banking
Sector Leader
KPMG in Canada
T: +1 416-777-8686
E: mfilippelli@kpmg.ca

Simon Fishley
Director, Financial Services
KPMG in Brazil
T: +554135444828
E: smfishley@kpmg.com.br

Brian Hart
Principal, Financial Services –
Advisory Services
KPMG in the U.S.
T: +1 212-954-3093
E: bhart@kpmg.com

Howard Margolin
Partner, Financial Risk Management
KPMG in the U.S.
T: +1 212-954-7863
E: hmargolin@kpmg.com

Amy Matsuo
Principal and National Lead, Enterprise-
wide Compliance and Consumer
Regulatory Advisory
KPMG in the U.S.
T: +1 919-380-1509
E: amatsuo@kpmg.com

Lisa Newport
Associate Director, Financial Services
Regulatory Center of Excellence,
Americas' Region
KPMG in the U.S.
T: +1 202-533-3075
E: lisanewport@kpmg.com

Mark Price
National Tax Leader,
Banking and Capital Markets
KPMG in the U.S.
T: +1 202-533-4364
E: mhprice@kpmg.com

John Schneider
Partner and National Lead, Investment
Management Regulatory Advisory
KPMG in the U.S.
T: +1 617-988-1085
E: jjschneider@kpmg.com

Tracy Whille
Principal and National Lead,
Capital Markets Regulatory Advisory
KPMG in the U.S.
T: +1 212-954-2691
E: twhille@kpmg.com

Contact us

Jeremy Anderson
Chairman Global Financial Services
KPMG
T: +44 20 7311 5800
E: jeremy.anderson@kpmg.co.uk

David Sayer
Global Head of Banking
KPMG
T: +44 20 7311 5404
E: david.sayer@kpmg.co.uk

Michael J Conover
Global Sector Leader,
Capital Markets
KPMG in the U.S.
T: +1 212-872-6402
E: mconover@kpmg.com

Scott Marcello
National Leader, Financial Services
KPMG in the U.S.
T: +1 212-954-6960
E: smarcello@kpmg.com

Brian Stephens
National Sector Leader, Banking and
Capital Markets
KPMG in the U.S.
T: +1 312-665-2154
E: bbstephens@kpmg.com

John Ivanoski
Partner and National Leader of
KPMG's U.S. Financial Services
Regulatory Practice
KPMG in the U.S.
T: +1 212-954-2484
E: jivanoski@kpmg.com

Pam Martin
Managing Director, Financial Services
Regulatory Center of Excellence
Americas' region
KPMG in the U.S.
T: +1 202-533-3070
E: pamelamartin@kpmg.com

Giles Williams
Partner, Financial Services
Regulatory Center of Excellence
EMA region
KPMG in the U.K.
T: +44 20 7311 5354
E: giles.williams@kpmg.co.uk

Simon Topping
Principal, Financial Services
Regulatory Center of Excellence
ASPAC region
KPMG in China
T: +852 2826 7283
E: simon.topping@kpmg.com

kpmg.com
www.kpmg.com/regulatorychallenges

© 2014 KPMG International Cooperative ("KPMG International"), a Swiss entity. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. NDPPS 259274 Printed in the U.S.

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Produced by KPMG's FS Regulatory Center of Excellence – Americas' Region

Publication name: Evolving Banking Regulation Americas Region

Publication date: March 2014