



SIFMA Compliance & Legal Society 2010 Annual Seminar

BANK REGULATION PANEL

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Bank Regulatory Issues – panel members

Moderator:

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Panelists:

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U.S. Bank Regulatory Regime -Overview

○ **Statutory Framework**

- Bank Holding Company Act
 - International Banking Act
 - Gramm Leach Bliley Act
- Permitted Activities
 - Reg Y
 - Reg K
- Certain Limitations on BHC Activities
 - Beneficial ownership of equity securities
 - Merchant banking
 - Affiliate transactions
 - Anti-tying



U.S. Bank Regulatory Regime- Overview

○ **Banking Regulators**

- Board of Governors of the Federal Reserve
 - Supervision of bank holding companies (including Foreign Banking Organizations)
 - Examination authority/oversight of state chartered member banks
 - Prudential, “umbrella” oversight of functionally regulated nonbank subsidiaries of BHCs
- Office of the Comptroller of the Currency
 - Supervision of national banks
- Federal Deposit Insurance Corporation
 - Supervision of insured depository institutions
 - Supervision of state chartered non-member banks
 - Resolution authority for failed insured depositories



U.S. Bank Regulatory Regime- Overview

- **Banking Regulators (cont'd)**
 - Office of Thrift Supervision
 - Supervision of savings & loans
 - State Banking Regulators
 - Supervision of state chartered member banks (shared with Federal Reserve)
 - Supervision of state chartered non-member banks (shared with FDIC)



U.S. Bank Regulatory Regime- Overview

- **Approach to Supervision of BHC Activities**
 - Principles-based, to ensure safety and soundness of banking organizations
 - Objective is to protect viability of banking subsidiaries
 - Comprehensive, risk-focused review for adequacy of BHC governance structure
 - Risk management
 - Financial condition
 - Impact on bank operations
 - Key areas of assessment
 - Board oversight
 - Adequacy of internal controls (including over capital/liquidity)
 - Effective risk management programs
 - Contingency planning



Becoming a BHC- Practical Updating the Compliance Program

- **Practical Considerations for a “new” BHC**
 - Formal, Board-approved appointments, mandates and programs
 - Chief Compliance Officer role
 - Global compliance plan
 - Formal articulation of compliance governance structure
 - Board oversight (roadmap)
 - Senior management accountability
 - Reporting line for Chief Compliance Officer
 - Dedicated monitoring and testing function
 - Staff training on becoming an FHC (Compliance and firm-wide)



Becoming a BHC- Updating the Compliance Program

○ **Practical Considerations (cont'd)**

- Relationships with Banking Regulators
 - Designating firm representatives as primary points of contact with the Federal Reserve, OCC
 - Establishing regular, periodic communications
 - Providing updates on developments with functional regulators



Becoming a Bank Holding Company – Updating the Compliance Program (Evan Charkes & John Ricketti)

Federal Reserve Supervision and Regulation Letter 08-8 (October 2008)

Targeted to Organizations defined as Large and Complex

- Size test is \$50bn or more in consolidated assets
- Complex – activities cross business lines, legal entities, jurisdiction

Sets minimum standards for Firm-wide Compliance Program and oversight

- Program documented in the form of Policies and Procedures
- Oversight provided by separate Corporate Compliance Function



SR LETTER 08-8

- Endorses 2005 Basel Banking Principles articulated by Basel Committee on Banking Supervision
- Describes Key Elements of Strong Risk Management
- Highlights importance of:
 - Independence of Compliance staff
 - Comprehensive Risk Assessment
 - Compliance Monitoring and Test Program
 - Oversight Responsibilities of Board and Sr. Management



SR LETTER 08-8

Independence of Compliance Staff

To minimize potential conflicts of interest, Compliance Staff must be independent of the business lines where they have compliance responsibilities

If dual reporting lines exist adhere to minimum standards:

- Key role of Corporate Compliance in actions affecting business line compliance staff and local compliance staff
- Compliance staff not compensated on basis of business line financial performance
- Enhanced Corporate Oversight applied on issues arising from conflicts of interest that affect business line compliance staff.



SR LETTER 08-8

Compliance Risk Assessment

- **Comprehensive**
 - Inventory of laws and regulations map to business line activities
- **Based on firm-wide standards**
 - Firm-wide method established to assess risk
 - Use of firm-wide criteria to assess risk
- **Consider**
 - Inherent risks of the activity
 - Effectiveness of controls to mitigate risks



SR LETTER 08-8

Compliance Monitoring and Testing Program

- Driven by Comprehensive Risk Assessment
- Scope and frequency of program based on the Compliance Risk Assessment



SR LETTER 08-8

Compliance MIS

- Key element of strong risk management program: reporting and escalation

- Elements of effective Compliance MIS
 - Clear
 - Accurate
 - Timely
 - Consistent with the firm's activities
 - Information sufficient to identify adverse trends, evaluate levels of risk



Non Bank Subsidiaries – Consumer Compliance Supervision CA 09-08

- Policy Effective September 14, 2009
- Covers Large, Regional, Community and Foreign Bank Holding Companies
- Allows for Risk Based Consumer Compliance Exams to be conducted at Non Bank Subsidiaries
- Allows for Investigation of Consumer Complaints at Non Bank Subsidiaries



Non Bank Subsidiaries – Consumer Compliance Supervision CA 09-08

- Exams will assess Consumer Compliance Risk Management Program
- Exams will test for compliance with applicable Consumer Protection Laws and Regulations
- Exam ratings will be provided (Strong, Satisfactory, Fair, Marginal, Unsatisfactory)
- Written Reports will be transmitted to senior Management of Nonbank subsidiary
- Exam Finding will be considered in the overall Bank Holding Company Rating



Role of Audit and Bank Holding Company Supervision

- **Bank Holding Company Supervisor:**
 - Ability to look at the role of audit across all entities
 - Domestic institutions – generally one global audit function covers all entities including subsidiaries
 - Foreign institutions – may have a US audit group or could have separate audit functions at stand alone subsidiaries; evaluation of audit performed for all entities



Role of Audit and Bank Holding Company Supervision

- **Leveraging off of internal audit:**
 - Evaluation of audit – critical component of BHC supervision
 - If audit is effective, supervisors can leverage off audit and reduce or change the scope of work performed
 - Key issues for leverage – scope and timeliness of audit reviews



Review of Internal Audit

- Internal Audit Reviews – Critical Component of Supervision Processes
- Detailed Review of Internal Audit - required every three years under Consolidated Supervision; standards we benchmark against include IIA standards
- Analysis of Audit includes four key components:
 - The Role of the Audit Committee and Internal Audit Department Independence and Competency - active Audit Committee/Board oversight, an independent reporting line for audit, audit resources/qualifications/skills, detailed MIS on audit activities
 - Internal Audit's Methodology, Plan, and Risk Assessments
 - Quality of Audit Work - planning memo, scope, audit program, work papers, appropriate sample sizes, adequate documentation
 - Audit's Ancillary Processes – audit reports, audit tracking system



New Areas of Emphasis by Internal Audit

- Evaluation of governance and strategic processes – should be focusing on tone at the top
- Analysis of cross business and functional risks
- Identification and escalation of thematic control issues
- Challenging the adequacy of controls – particularly in risk management and cross-institutional
- Informing management of key infrastructure weaknesses
- Understanding management's business strategy and risk tolerance – clear articulation
- Evaluation of fraud risk and its impact on specific areas
- New products and profitability – involvement of audit



Internal Audit “Best Practices” and “Trends”

- **“Best Practices”:**
 - Quarterly Continuous Monitoring or Auditing
 - Training in Fraud Risk
 - Quality Assurance
 - Independent Review of Internal Audit
 - Computer Assisted Auditing (CAAT)



Internal Audit “Best Practices” and “Trends”

- **Trends at Some Large Institutions**

- No audit cycle – “high risk” areas audited annually – requires robust risk assessment and effective quarterly continuous monitoring
- Global audit coverage with matrix reporting lines based on business considerations – e.g. separate group for investment management and private banking



Retail Bank/Brokerage Issues (John Avanian)

○ Regulation R: Practical Overview from Retail Perspective

- In 2008/2009: implemented provisions of Gramm Leach Bliley Act of 1999
- Joint regulation of the SEC and the Federal Reserve
- Third-party networking arrangements and incentive compensation
 - “Incentive Compensation” is “intended to encourage a bank employee to refer customers to a broker or dealer, or give a bank employee an interest in the success of a securities transaction.”
 - Does not include a compensation paid by a bank under a bonus or similar plan that is:
 - Paid on a discretionary basis; and
 - Based on multiple factors or variables and
 - Are not related to securities transactions at the broker-dealer;
 - A referral by an employee is not factored into compensation under the plan; and
 - The employee’s compensation is not determined by reference to referrals made by others.



Retail Bank/Brokerage Issues

○ **Regulation R**

- Unlicensed bank employees generally may receive discretionary bonuses based on the overall profitability or revenue of:
 - The Bank;
 - Any affiliate other than a broker-dealer; or
 - A broker-dealer, if:
 - One of several factors or variables used;
 - Including multiple, significant factors or variables not including brokerage revenue or profitability; and
 - Referral by that employee or any other not a factor.



Retail Bank/Brokerage Issues

○ **Bank Deposit Sweep Programs**

- Use of negative consent to establish bank sweep programs
- NYSE Information Memo 05-11
- Exchange Act Release No. 34-55431 (March 9, 2007)
 - SEC proposed amendments to Rule 15c3-3 to add new section regarding treatment of free credit balances.
 - Proposed FINRA Rule 3260 (replacing NASD Rule 2510), would not address bulk transfers from money market mutual to bank sweep programs.
- Areas of recent regulatory focus in connection with bank sweeps



Bank Regulatory Oversight of Institutional Securities Activities (Karen Kirchen)

- Key Concepts in a “Post-Crisis” Environment
 - Enhanced focus on risk takers
 - Fundamental governance initiatives
 - Risk-aligned compensation policies
 - Accountability mechanisms (clawbacks)
 - Heightened scrutiny of risk-management practices
 - Procedures and tools relevant for the specific business activities of the BHC
 - Articulation of risk appetite, and means for measuring and monitoring compliance with Board-approved strategies
 - Robust governance reviews and stress testing
 - Targeted, critical assessments of capital and liquidity management
 - Risk-based capital (with capital “cushions”)
 - Liquidity plans (including contingency funding plans)



Bank Regulatory Oversight of Institutional Securities Activities

- **Regulatory concerns regarding Liquidity Management**
 - View that liquidity issues drove investment bank failures
 - BHC must maintain consolidated, as well as legal-entity based, picture of liquidity position and ongoing needs
 - Need for adequate and transparent mechanisms to
 - Evaluate portfolios and inventory
 - Govern mark-to-market protocols
 - Independently verify accuracy of pricing (mark-to-market), valuation
 - Identify and address market risk
 - Identify and address credit exposures
 - BHC operational risk controls to include collateral management
 - Knowledgeable of collateral held and posted, including triggers for increasing or decreasing amounts
 - Ability to access posted collateral



Bank Regulatory Oversight of Institutional Securities Activities

- **Significant Limitations on Capital Market Activities**
 - Transactions with affiliates
 - Specific concerns around banks and BHCs, and related Section 23A issues
 - Cross-marketing restrictions
 - Anti-tying
 - Merchant banking restrictions
 - BHCs (but not banks) may make equity investments in non-financial companies
 - Limits on holding period
 - Section 23A and cross-marketing restrictions



Legislative Developments – All

- **Regulatory Reform**

- High level overview of status of U.S. legislative reform initiatives
- Significant legal issues
- Anticipated impact on BHC compliance platforms