Positioning for change

US financial reform six months later

Ernst & Young

Quality In Everything We Do

US financial reform accelerates

Dodd-Frank's first six months and the road ahead

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) reached its half-year milestone on 21 January 2011. In the six months since it was signed, the process of establishing new regulatory bodies and formulating rules for implementation has ramped up considerably. Much hard work still remains, however, to fully define the regulatory landscape through rule-making. The sheer number of rules to be written, the breadth and complexity of the issues with which they must deal, and the need for multiple agencies to be involved, will, in some cases, make meeting the one-year deadlines for many of the rules a challenge for regulators. In any event, we can expect the pace of issuance to accelerate considerably as we approach the one-year mark and the topography to become increasingly more defined.

The range of proposals and requests for public input, and the actions of prudential regulators to date, reflect the breadth and complexity of the changes in progress. Firms now have some sense of direction, if not the final details, as they begin to prepare for the new financial regulatory framework. For example, the Office of Financial Research (OFR), the entity charged with information gathering and analysis in support of the Financial Stability Oversight Council (FSOC), has begun to reveal its thinking regarding data standards, starting first with unique legal-entity identifiers. It has also indicated its intent to require very granular, transaction-level reporting in as close to real time as possible. In addition, many of the proposals set out some preliminary criteria regarding key elements of reform, such as defining "dealers" and "major swap participants" for the purposes of the OTC derivatives provisions of Dodd-Frank. The expectations of prudential supervisors for the largest banking organizations have continued to rise as they have begun work on stress testing and capital planning, regulatory reporting and bank recovery and resolution plans (or living wills). These initiatives are providing some insight into the sorts of enhanced prudential standards that systemically important financial institutions (SIFIs), both banks and non-banks, might see in the future.

Despite the remaining uncertainties about precise regulatory definitions and requirements, the financial services sector has begun to take action in anticipation of the new rules, based on what can be determined, or at least broadly understood, at this early juncture. Firms are conducting impact assessments to understand both the strategic and operational implications of the reform agenda and their readiness to address new requirements. Some institutions are already making significant changes where the direction of rule-making appears sufficiently clear.

Given the broad impact of the statute on many firms' business models and infrastructure, early mobilization is critical not only to comply with new regulatory standards, but to identify strategic opportunities. Further, the first half of 2011 will bring a period of intensive rule-making across the major components of the Act. Even allowing for comment periods, firms should expect short implementation windows when the rules are finalized. And as they implement Dodd-Frank, banking organizations will also be wrestling with the strategic ramifications of Basel III, the Basel Committee on Banking Supervision's new Capital Accord and the new liquidity regime that accompanies it, which were issued on 16 December 2010 and will likely have to be addressed during the same time period.

So while a great deal remains to be decided, the regulatory activity during Dodd-Frank's first six months has shed some light on the road ahead, and the next six months will be a critical period for financial services institutions.

The journey's first leg

A far-reaching impact already

During the first six months, regulatory activity related to Dodd-Frank has been mostly preparatory. However, it has had a profound effect on many aspects of the financial services industry nonetheless. The activity has centered on a number of key areas.

- **Market stability and systemic risk.** The FSOC, the systemic-risk watchdog comprising representatives from the federal financial regulatory agencies and chaired by the Secretary of the Treasury, first met on 1 October 2010 and has since issued early proposals on how systemic risk could be assessed for non-bank financial companies, indicating areas in which increased reporting and supervision are likely. Moreover, the council's early activities suggest an ambitious agenda that may target gathering granular, real-time, transaction-level data across the markets to identify emerging market issues.

- **Enhanced prudential regulation and supervision.** Prudential supervision of large banks continued to evolve even in advance of new US regulations. There is an emerging focus on recovery and resolution plans and a second round of supervisory stress tests, both of which are expected to be Dodd-Frank requirements for systemically important firms. Meanwhile, proposed rule-making under the Collins Amendment would, among other things, create a permanent floor under the Basel II capital framework at the Basel I levels, to be incorporated into current bank and holding company capital rules.

- **The Volcker Rule.** Some banks have begun to wind down or spin off proprietary trading operations in anticipation of this mandate, notwithstanding the extended period allowed to conform. The study issued by the FSOC on 19 January 2011 recommends a strict monitoring and compliance framework for banks, intended to thwart any unsanctioned proprietary trading activity.

- **Greater transparency and disclosure.** Under Dodd-Frank, credit rating agencies are subject to greater transparency and Securities and Exchange Commission (SEC) oversight requirements, as well as increased liability exposure. Dodd-Frank also specifies that all references to credit ratings be removed from regulations and federal laws by July 2012. Regulators issued a public rule-making announcement on potential alternatives to credit rating agencies in 2010, pointing out that the statutory requirement poses significant challenges with no obvious alternatives readily available. Restrictions on the use of external ratings raised market concerns and almost immediately required temporary stop-gap regulatory action.

  The SEC and the Commodity Futures Trading Commission (CFTC) have undertaken extensive rule-making regarding over-the-counter derivatives clearing and disclosure aspects of the Act. On the buy side, hedge funds and private equity firm advisers that will be required to register with the SEC have begun to put in place the compliance and reporting infrastructure they will need.

- **Consumer and investor protection.** Regulators have been busy with respect to both consumer and investor protection measures. So far, they have acted largely under mandates that were in force prior to Dodd-Frank, but in ways consistent with the Act. The Federal Reserve's proposed rules on debit card interchange fees, issued in December 2010, demonstrated the potential business implications of the statute's consumer protection provisions, in this case, on consumer banking revenues. Looking beyond the financial sector to public companies at large, the SEC has issued rules to increase disclosures and voting rights for shareholders with respect to executive pay.

Snapshot: Dodd-Frank at six months

Regulatory actions

- Hundreds of rules still have to be written. At the six-month mark, there has been preliminary action on roughly one-quarter of the rule-making agenda, with a primary focus on OTC derivatives, investor and consumer protection and systemic regulation.
- Numerous studies have been issued that will lay the groundwork for future rule-making, and many more remain in progress.

Supervisory actions

- The FSOC has issued a proposed rule on determining criteria for systemically important institutions.
- OFR proposals to date have focused on standards for data collection and legal-entity identification.
- The Federal Reserve Board (FRB) has allocated funding, as required by the statute, for the new Consumer Financial Protection Bureau (CFPB).
- The December 2010 report of the Senior Supervisors Group (SSG), which is chaired by the Federal Reserve Bank of New York, includes the contributions of US regulatory agencies. It highlights weaknesses that the industry needs to address related to risk appetite frameworks and IT infrastructure.
- Large US banks are required to develop recovery and resolution plans (living wills) to provide supervisors with information on how they would be able to respond to severe erosion of capital and/or liquidity that threatened their viability.
- Dodd-Frank and the Supervisory Capital Assessment Program reinforce emphasis on stress-based capital adequacy for large banks through the second round of stress tests undertaken by the 19 largest US banks. The stress tests required institutions to consider capital adequacy consistent with the Basel III standards, accelerating institutions' assessment of the capital impact of the transition to stricter standards.

Industry actions

- Some proprietary trading operations at banks are winding down or being spun off in preparation for the Volcker Rule transition period.
- Firms with significant activities in capital markets are reassessing their business models to address the new standards for OTC derivatives.
- The industry is commenting on the proposed rules, but there is some concern over the fast pace of the rule-making. The sheer volume and sequencing of rule-making related to derivatives, in particular, complicates the public comment process.

Global initiatives

- Basel III final rules were issued on 16 December 2010, including agreement on the application of countercyclical capital buffers at the discretion of national supervisors.
- The G-20 has been focusing on systemic risk, too big to fail and effective resolution regimes, including proposals to reduce systemic risk.

Where on the map are we?

Industry responses to date

Financial firms are at different stages in their responses to Dodd-Frank. However, several sound practices and key priorities can be identified from the ongoing industry activities and consensus on where priorities lie. These include the following.

- **Assessing and anticipating impact.** The banking sector, and in particular, global firms with substantial activity in the capital markets, are most affected by the early-term rule-making and are generally the most advanced in their responses and analyses of Dodd-Frank's impacts. Large non-bank financial companies are beginning to direct their attention to the effect of potential SIFI designation, which would introduce additional scrutiny and regulatory oversight, higher capital and other prudential standards, and changes to numerous operating requirements. Many of the largest institutions have begun to perform structured impact assessments across the full scope of the Act. They have started to develop roadmaps and governance structures to assist with both priority implementation activities and change management over an extended period during which specific regulatory requirements are finalized and compliance becomes necessary. Global institutions are also assessing the impact of Dodd-Frank within the larger context of regulatory change initiatives in other key jurisdictions, and coordinating these efforts accordingly.

- **Mobilizing response programs.** Managing the sweeping, multiyear changes mandated by Dodd-Frank is leading an increasing number of the largest banks to establish robust governance and program management offices (PMOs) to oversee and manage their responses to the new regulatory requirements. Given the strategic impact of Dodd-Frank on the organization, the leader for the implementation effort has often been from a line of business or the corporate strategy function. In their assessments, institutions have concentrated on understanding the business impacts and strategic opportunities created by the Act, as well as the increased compliance costs. In addition, enterprise-level program governance has focused on oversight of implementation efforts and establishing processes to track and manage the emerging rule-making.

- **Starting priority implementations.** Institutions have set priorities and begun implementation where the regulatory road forward is generally known, as well as where implementation windows are short or lead times long. Priority actions to date have often centered on OTC derivatives and the Volcker Rule, in addition to reassessing the impact on projects already in progress. Many institutions are beginning to evaluate the enterprise-wide effect of the Act as it relates to data quality, reporting, infrastructure and governance and are planning investment needs accordingly.

Checklist: near-term action items

- ☑ Develop and execute multidisciplinary impact assessments
- ☑ Establish dynamic frameworks to update assessments for rule-making and industry developments
- ☑ Develop prioritized roadmaps
- ☑ Establish program management office and governance structure
- ☑ Establish rule-making monitoring and management process for both US and global initiatives
- ☑ Develop readiness assessments and mock exams in specific areas
- ☑ Evaluate enterprise-wide impact on data and IT capabilities and review investment plans
- ☑ Begin to develop and execute plans for priority implementation projects

Staying ahead of the curve

The destination becomes clearer

The next six months will see a sharp increase in activity as regulators approach the one-year mark, which calls for final rules to be in place for a host of the Act's provisions. Among these are: establishing the CFPB; creating rules governing securitizations, central clearing and disclosure for OTC derivatives; registration for advisers to hedge funds and private equity funds; non-bank financial firm SIFI criteria; living wills; and prudential standards for large bank holding companies. At this point, it is crucial for financial firms to have effective programs established to meet new requirements and supervisory expectations. Over the coming months, most of the reform-related challenges for the financial services sector will fall broadly into six main categories.

1. **Program management.** Firms should establish and sustain dynamic processes and governance for assessing the multidimensional effect of Dodd-Frank across complex businesses, prioritizing action plans and managing the "unknowns" — such as future rule-making impacts, market responses and relevant non-US reform initiatives — all while adequately tracking and managing multiple implementation projects. Early stages of effective program management should include:

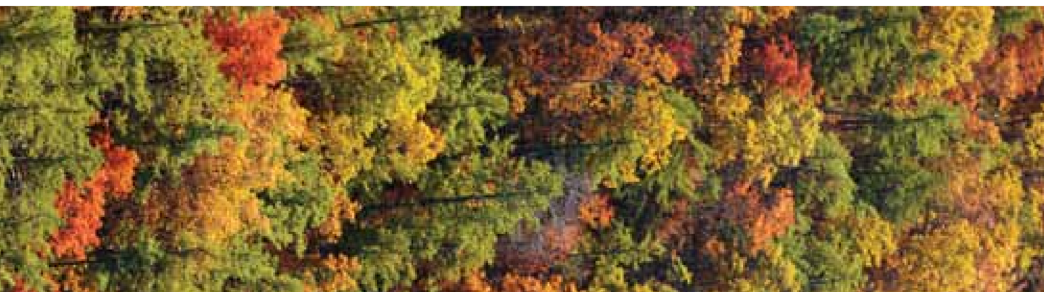
   - Setting up a formal governance structure to oversee the firm's program, including the rule-making management process
   - Undertaking an actionable impact assessment that considers financial, operational and technology effects, as well as the effects on current plans and in-flight projects
   - Developing a strategic and tactical roadmap and decision-management process to determine investment needs, resource requirements and project interdependencies and to manage the risk posed by uncertainty
   - Identifying and initiating priority implementation efforts

2. **OTC derivatives clearing.** The extent of the changes to the derivatives markets and their as-yet unknown impact on the economics of various derivatives product lines present challenges. These are heightened by the fact that many of the new regulatory changes are reported to be in force by July 2011. A robust analysis of Dodd-Frank's impact includes evaluating implementation costs and long-term business strategy and opportunities. This typically requires a firm to review such elements as:

   - Business model
   - Product mix
   - Client model
   - Legal-entity structure and capital needs
   - Clearing and settlement options
   - Collateral management and payments processes
   - Reporting requirements

3. **OFR and regulatory reporting impact on data.** The new research agency has broad authority to request data, and early indications suggest that it intends to take a proactive and expansive approach to data collection and analysis. Firms will need to enhance data and reference standards, including unique legal-entity identifiers. Institutions may need to produce granular, transactional information rapidly, including timely reconciliation of risk and finance data, which could place a strain on data management at many firms that must also manage data privacy concerns. Preparing for these demands involves a number of challenges, including:

   - Establishing clear data governance and quality programs, with the initial focus on priority subject areas
   - Reviewing counterparty and account identification models across the firm



- Identifying sources of all financial transactional data and underlying supporting data, as needed (e.g., for structured products or mortgages)

- Aligning internal taxonomies with those of the OFR

4. **Prudential supervision of SIFIs.** The new systemic risk oversight regime will require firms to fully understand the impact of increased expectations for banking organizations, non-banks and financial market utilities designated as SIFIs. Standards will address capital and liquidity requirements, expanded reporting on credit exposures to other financial firms, and recovery and resolution plans, as well as extensive stress testing programs and overall improvements to risk management and governance structures. Priority items to be considered include:

   - Readiness assessments relative to supervisory expectations for firms facing systemic designation and consolidated FRB supervision for the first time

   - Development of a comprehensive plan for the transition to enhanced supervision

   - Assessment and potential build-out of risk management and governance frameworks to meet heightened supervisory expectations, including build-out of supporting processes and reporting

   - Improvements to reporting infrastructure, risk systems, risk frameworks, IT infrastructure and IT operational processes to meet regulator expectations for risk management

5. **IT and data management.** Demand for data and reporting is pervasive throughout the Act. Data that have not hitherto been reported to regulators, derived from financial, risk and management information, as well as compliance environments, will need to be sourced, reconciled and standardized. A firm's IT infrastructure will likely need to be capable of linking data across risk disciplines, aggregating and reconciling risk and finance data, tracking performance and compensation, and managing and reporting on capital and liquidity requirements. Legal-entity views of information and reporting will also be important. Given the significant lead time necessary to execute an integrated information strategy and architecture plan, firms will have to scope and implement multiyear projects to enhance their IT infrastructure and data management capacity.

6. **Consumer protection.** Firms should be aware of the focus of the new CFPB and other agencies and monitor ongoing developments. While the CFPB will not be operational until later in 2011, consumer protection will continue to be a matter of heightened regulatory focus. The Federal Reserve recently issued a proposed rule creating a ceiling for interchange fees for debit cards. And changes to rules on mortgage appraisers or interest paid on deposits, for example, could have significant business consequences. Priority steps to take include:

   - Evaluating product, feature and service offerings, to ensure appropriate products are redesigned or retired to meet new requirements and to determine the impact on future revenue

   - Determining enhancements for consumer disclosures, data collection requirements and IT architecture improvements

   - Addressing enhanced expectations around data collection and reporting and their use in risk analysis

The next six months

The experience of the first six months of Dodd-Frank has confirmed that adapting to the new regulatory framework will require firm-wide changes. Financial services institutions should take action now to evaluate their readiness to manage this change in the coming year; put in place appropriate governance structures and processes; and initiate implementation projects to address the priority aspects of the Act coming up during the next six months.

January–March 2011

Studies:
- FSOC — Volcker Rule; concentration limits; risk retention (securitization)
- SEC — fiduciary duty; investment adviser examinations
- Interagency transition plan for Office of Thrift Supervision (OTS)

Rule-making:
- FSOC notice of proposed rule-making (NPR) determining SIFI criteria for non-bank financial companies and financial market utilities (FMUs)
- SEC NPR on adviser registration
- Interagency NPR on living wills

April–June 2011

Rule-making:
- SEC NPR on proxy disclosure rules on incentive compensation
- SEC final whistleblower rule
- FRB final rule on debit interchange fees
- FRB NPR regarding enhanced prudential standards for large BHCs
- FSOC to issue non-bank and FMU SIFI criteria (target date)

July 2011

One-year milestones
Effective dates and rules finalized:
- OTC derivatives
- Asset-backed security (ABS) conflict and retention rules
- FSOC initial determination of SIFIs
- CFPB established (21 July 2011)
- OTS abolished
- Interest on non-maturity deposit accounts allowed
- Legal-entity identifier target date (15 July 2011)

Rule-making:
- Proprietary trading rules (i.e., Volcker Rule)

CFTC and SEC to issue rules throughout regarding OTC derivatives and swap clearing

Regulatory actions	▸ OTC derivatives will continue to be a central focus of rule-making with effective dates for new capital requirements, exchange reporting and additional compliance standards all falling on the one-year anniversary of the Act. ▸ Study results will lead to implementation and increased pace of rule-making.
Supervisory actions	▸ SIFIs (both bank and non-bank) face increased regulation and oversight, as well as enhanced prudential standards (risk management practices, leverage, liquidity and exposure limits). ▸ Supervisory Capital Assessment Program stress testing and OFR efforts will compound existing data management and reporting challenges. ▸ Risk retention and conflict of interest requirements will transform ABS construction.
Industry	▸ Firms will need to establish effective program management processes to implement the multidimensional requirements of the Act. ▸ Firms will need to determine needed changes in their business organization and activities in light of Volcker Rule's prohibitions on proprietary trading, hedge fund and private equity activities. ▸ The broad changes to the OTC derivatives market will cause firms to re-evaluate their business activities, products, strategy and profitability. ▸ In light of OFR data efforts, firms will need to address system and process needs to meet granular data requirements. ▸ Product strategies and compliance processes will need to be implemented both for consumer and wholesale businesses, due to new securitization requirements and CFPB rules.
Global initiatives	▸ Greater G20 focus on consumer protection issues, as well as the trading book. ▸ The Financial Stability Board is expected to lay out a framework for identification of global SIFIs and recovery and resolution framework (June 2011). ▸ Accounting convergence will move closer to a single set of improved high-quality standards (December 2011).
Political and regulatory	▸ New "split" Congress with Republican House majority is not expected to impact the legislation, but the implementation process may be affected by increased congressional oversight and funding constraints. ▸ Interagency coordination is essential with respect to the establishment and mobilization of the CFPB and OFR and to the transition of OTS authorities to the Office of the Comptroller of the Currency.

Ernst & Young can help

The six months since the enactment of Dodd-Frank have demonstrated that compliance with new regulations will require financial services institutions to execute enterprise-wide changes. Stakeholders across the organization will need to work together, and, in many cases, institutions will need to execute well-coordinated, multiyear projects with the flexibility to adapt to evolving regulations.

Even though many regulatory requirements are in their infancy, getting an early start is critical. To learn more about our regulatory advisory services and how we can help your organization, please visit www.ey.com/us/financialservices or contact one of our financial services professionals.

Hank Prybylski
Partner
Advisory Leader
Financial Services
Ernst & Young LLP
+1 212 773 2823
lawrence.prybylski@ey.com

Peter Davis
Principal
Financial Services
Ernst & Young LLP
+1 212 773 7042
peter.davis@ey.com

Don Vangel
Principal
Advisor, Regulatory Affairs,
Office of the Chairman
Financial Services
Ernst & Young LLP
+1 212 773 2129
donald.vangel@ey.com

Bob Reinhold
Principal
Financial Services
Ernst & Young LLP
+1 703 747 1967
bob.reinhold@ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 141,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global and of Ernst & Young Americas operating in the US.

Ernst & Young is a leader in serving the global financial services marketplace

Nearly 35,000 Ernst & Young financial services professionals around the world provide integrated assurance, tax, transaction and advisory services to our asset management, banking, capital markets and insurance clients. In the Americas, Ernst & Young is the only public accounting organization with a separate business unit dedicated to the financial services marketplace. Created in 2000, the Americas Financial Services Office today includes more than 4,000 professionals at member firms in over 50 locations throughout the US, the Caribbean and Latin America.

Ernst & Young professionals in our financial services practices worldwide align with key global industry groups, including Ernst & Young's Global Asset Management Center, Global Banking & Capital Markets Center, Global Insurance Center and Global Private Equity Center, which act as hubs for sharing industry-focused knowledge on current and emerging trends and regulations in order to help our clients address key issues. Our practitioners span many disciplines and provide a well-rounded understanding of business issues and challenges, as well as integrated services to our clients.

With a global presence and industry-focused advice, Ernst & Young's financial services professionals provide high-quality assurance, tax, transaction and advisory services, including operations, process improvement, risk and technology, to financial services companies worldwide.

It's how Ernst & Young makes a difference.

© 2011 Ernst & Young LLP

All Rights Reserved.

SCORE no. CK0413

1101-1222140 NY

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.