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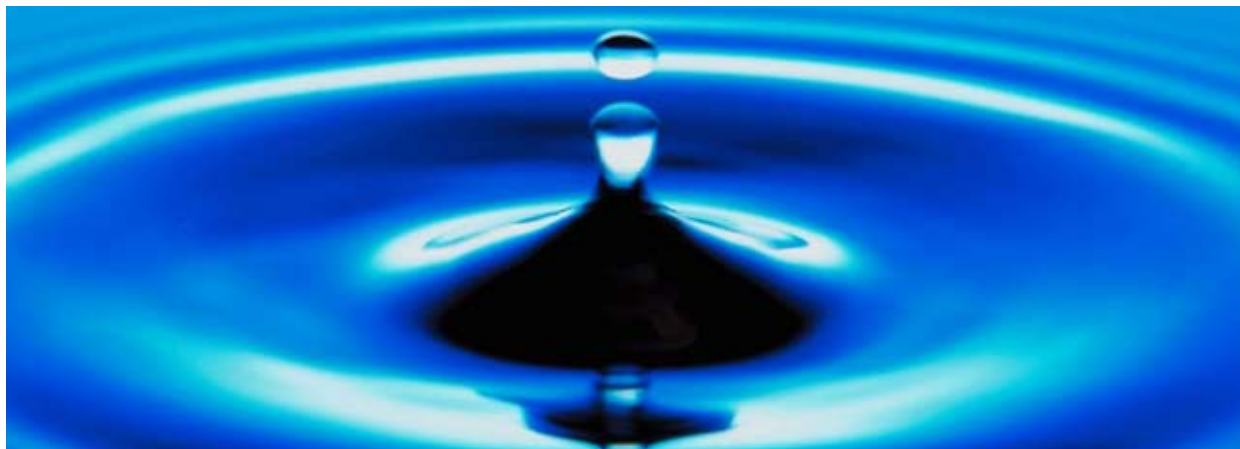
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News Bulletins: Banking

Third Stage of Implementation of the Credit Card Act

The Credit Card Accountability Responsibility and Disclosure Act of 2009 (Credit Card Act) was signed into law on May 22, 2009 to strengthen consumer protection in the credit card market by establishing fair and transparent practices for open-end consumer credit plans. The first stage, which addressed advance notice of rate increases and the amount of time that consumers have to make payments, was implemented on August 20, 2009. The second stage, which focused on, among other things, provisions regarding interest rate increases, over-the-limit transactions and student cards, became effective on February 22, 2010.

On March 3, 2010, the Federal Reserve Board (FRB) proposed a rule¹ amending Regulation Z (Truth in Lending Act) in order to implement the third and final stage of the Credit Card Act. This stage will be effective August 22, 2010 and will focus on prevention of large penalty fees imposed by credit card issuers for small slip-ups by consumers, as well as on requiring the credit card issuers to reevaluate rate increases imposed since the beginning of 2009.

Specifically, the proposed rule would:

- Prohibit credit card issuers from charging penalty fees that:
 - Are not reasonable or proportional to the omission or violation to which the fee or charge applies, but allow an issuer to charge a penalty fee for a particular type of violation (e.g., late payment) if:
 - The amount of the fee represents a reasonable proportion of the costs incurred by the issuer as a result of that type of violation (e.g., collection costs to notify consumers of delinquencies and resolve those delinquencies), or
 - The amount of the fee is reasonably necessary to deter that type of violation; or
 - Exceed the dollar amount associated with the violation (e.g., over-the-limit fee penalty cannot exceed the amount by which the consumer has exceeded the credit limit)
- Ban inactivity fees, such as those based on the consumer's failure to use the account to make new purchases
- Prevent issuers from charging multiple penalty fees based on a single late payment or other violation of the account terms

- Require credit card issuers to inform consumers of the reasons for increases in rates
- Require issuers that have increased rates since January 1, 2009 based on the credit risk of the consumer, market conditions, or other factors, to evaluate whether the reasons for the increase have changed and, if appropriate, to reduce those rates. Reevaluation is required no less frequently than every six months and reasonable methodologies utilized for this reevaluation must be maintained

After the 60-day comment period, the FRB will issue the final rule.

Comptroller Dugan Speech on the Basel Committee Proposal

At the March 2010 Annual Institute of International Bankers Conference, Comptroller of the Currency, John C. Dugan addressed current reform efforts underway to guard against a future financial crisis. Comptroller Dugan said that the key challenge facing policymakers is to determine the correct amount of prudential reforms without impacting the optimal utilization of capital. He stated that his own views would be to further strengthen the financial system even if that meant there would be reduced credit available in the future.

Dugan then discussed in detail the steps taken by international organizations in regards to financial reforms, in particular the Basel Committee on Banking Supervision (the "Committee"). The Committee's response to the financial crisis was described in four papers issued in 2009. These documents, which describe the final changes to the Basel II framework and additional proposed changes, are "intended to promote a more resilient banking sector by strengthening the standards for capital, liquidity, and risk management."²

July 2009

*Guidelines for computing capital for incremental risk in the trading book*³

- Establishes higher capital requirements for credit risk in trading positions and introduces a stress-like test for value-at-risk (VaR) models.

*Enhancements to Basel II framework*⁴

- Introduces an incremental risk capital charge for unsecuritized credit products, which covers the risk of both default and non-default credit losses resulting from credit rating downgrades

- Raises capital charges for short-term liquidity facilities to off-balance sheet conduits
- Requires banks to conduct more rigorous credit analyses of externally rated securitization exposures

Taken together, the measures introduced in the July 2009 papers will significantly increase the level of capital held for trading purposes, while reducing the incentive for regulatory arbitrage between the banking and trading books.

*Strengthening the resilience of the banking sector*⁵

- Proposes changes intended to improve the loss-absorbing quality of capital by holding higher proportions of common stock
- Establishes an international leverage ratio backstop to the risk-based capital requirement
- Dampens pro-cyclical features of the current regulatory framework

*International framework for liquidity risk measurement, standards and monitoring*⁶

- Proposes a global minimum liquidity standard for internationally active banks, which includes both a 30-day liquidity coverage ratio and a longer-term structural liquidity ratio

In addition to the already issued papers, the Committee is undertaking the *Quantitative Impact Study*.⁷ This study will be used in conjunction with the comments received on the December 2009 consultative papers to help determine how much additional capital and liquidity is required for each of the proposed new standards, and how much higher overall capital and liquidity should be for each bank. This will also help policymakers determine the right balance between the amount of capital required for a robust banking system on one hand and optimal utilization of capital on the other hand.

The standards are to be finalized at the end of 2010 and implemented by 2012.

Interagency Policy Statement on Funding and Liquidity Risk Management

The Office of the Comptroller of the Currency, Treasury (OCC), Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision, Treasury (OTS), and National Credit Union Administration (NCUA), collectively ("the Agencies"),



in conjunction with the Conference of State Bank Supervisors (CSBS), released a statement on March 17, 2010, *Interagency Policy Statement on Funding and Liquidity Risk Management*,⁸ which outlines the agencies' expectations for sound funding and liquidity risk management practices. Principles of sound liquidity risk management, supplemented with the *Principles for Sound Liquidity Risk Management and Supervision* issued by the Basel Committee on Banking Supervision in September 2008,⁹ had been previously issued by the agencies. Given the "recent market turmoil,"¹⁰ the agencies are again stating the importance of effective liquidity risk management for the safety and soundness of financial institutions.

The policy statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal, well-developed contingency funding plan as primary tools for measuring and managing liquidity risk. The agencies expect each financial institution, *i.e.*, banks, thrifts, credit unions, to manage funding and liquidity risk using processes and systems that are commensurate with the institution's complexity, risk profile, and scope of operations. Additionally, they expect institutions to have well documented liquidity risk management processes and plans, documents which are to be available for supervisory review. Regulators will consider failure to maintain an adequate liquidity risk management process an unsafe and unsound practice.

Specific areas addressed in the statement include:

- Liquidity and liquidity risk
- Sound practices of liquidity risk management
 - Regulators will assess the elements of liquidity risk management in relation to the size, complexity and scope of operations for an institutions
- Corporate governance
- Strategies, policies, procedures, and risk tolerances
- Liquidity risk measurement, monitoring, and reporting
- Intraday liquidity position management
- Diversified funding
- Cushion of liquid assets
- Contingency funding plan
- Internal controls

The policy statement will go into effect 60 days after its publication in the *Federal Register*.

Guidance on Obtaining and Retaining Beneficial Ownership Information

The Financial Crimes Enforcement Network (FinCEN), the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission, recently issued guidance¹¹ to clarify regulatory expectations for obtaining beneficial ownership information for certain accounts and customer relationships. The information on beneficial ownership in account relationships provides a tool for financial institutions to better understand and address money laundering and terrorist financing risks.

The adoption and implementation of internal controls, including comprehensive customer due diligence (CDD) policies, procedures, and processes for all customers, particularly those that present a high risk for money laundering or terrorist financing is critical to a strong Bank Secrecy Act/Anti-Money Laundering (BSA/AML) compliance program. Conducting appropriate CDD assists an institution in identifying, detecting, and evaluating unusual or suspicious activity. Processes to identify customers who pose money laundering or terrorist financing risks should be developed.

Risks may arise with respect to beneficial owners of accounts because "nominal" account holders can enable individuals and business entities to conceal the identity of the true owner of assets or property derived from or associated with criminal activity. Customer due diligence is key. CCD procedures should be established to identify and verify the identity of beneficial owners. These may include:¹²

- Determining whether the customer is acting as an agent for or on behalf of another, and if so, obtaining information regarding the capacity in which and on whose behalf the customer is acting;
- Where the customer is a legal entity that is not publicly traded in the United States, obtaining information about the structure or ownership of the entity so as to allow the institution to determine whether the account poses heightened risk; and



- Where the customer is a trustee, obtaining information about the trust structure to allow the institution to establish a reasonable understanding of the trust structure and to determine the provider of funds and any persons or entities that have control over the funds or have the power to remove the trustees.

Accounts which have been identified as posing a heightened risk also should be subjected to enhanced due diligence in order to identify and verify the beneficial owners, understand the sources and uses of funds in the account and understand the relationship between the customer and beneficial owner.

The guidance also addresses requirements for private banking accounts and foreign correspondent accounts. The official guidance can be found at: http://www.fincen.gov/statutes_regs/guidance/html/fin-2010-g001.html

Feature Articles: Banking

Changes to Risk-Based Capital Rules Reflecting Issuance of FAS 166 and FAS 167

On January 21st, 2010, The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, “the Agencies”) published a final rule¹³ amending the risk-based capital rules to reflect the issuance of FAS 166 and FAS 167 (“the Final Rule”). The rule focuses on introducing a transition mechanism related to risk-weighted assets (RWA) and allowance for loan and lease losses (ALLL) affected by the implementation of FAS 166 and FAS 167, the elimination of the exclusion of certain asset-backed commercial paper (ABCP) from risk-weighted assets, and discusses the Agencies reservation of authority in regards to regulations around newly consolidated variable interest entities (VIE). The Final Rule was published following a *Notice of Proposed Rulemaking*¹⁴ (NPR) in August 2009, requesting commentary around risk-based capital back in an effort to take into consideration all feedback received.

The first topic of discussion in the Final Rule introduces a transition mechanism which delays the effect on risk-weighted assets resulting from FAS 166/167

implementation. The transition mechanism begins with an implementation delay referred to as the exclusion period. The exclusion period takes place during the first two-quarters following the implementation date of FAS 166 and FAS 167 in which a banking organization may choose to exclude assets held by VIEs from their risk-weighted assets (assets excluded referred to as the “exclusion amount”). In order to take advantage of this exclusion, a VIE must have existed and not been consolidated in past quarter-end regulatory reports prior to the implementation date. During the exclusion period, an organization may also exclude assets held by VIEs that are consolidated ABCP programs. A banking organization, however, must be the primary sponsor of the program, have previously consolidated the ABCP program VIE onto the balance sheet under generally accepted accounting principles (GAAP), and excluded the VIE’s assets from RWA prior to the implementation date. This exclusion does not apply to assets of a VIE which has received implicit support. During the exclusion period, a banking organization’s total RWA must be at a minimum equal to the RWA it would have calculated under the risk-based capital rules had FAS 166 and FAS 167 not been implemented.

The transition mechanism also consists of an optional partial implementation period, known as the phase-in period, following the two-quarter implementation delay. In order to opt for the phase-in period, a banking organization must have excluded assets of consolidated VIEs from RWA during the exclusion period. Therefore, a banking organization cannot implement the phase-in period if they did not implement the exclusion period. The phase-in period is permitted for the third and fourth quarters following the implementation date. During the phase-in period an organization may exclude 50% of the exclusion amount from RWA. The exclusion amount, however, must not be less than the total RWA had the newly consolidated VIEs not been consolidated. If a banking organization chooses to implement the transition mechanism, it must do so for all VIEs. The effect of the transition mechanism on a banking organization’s risk-based capital ratios will be captured in the organization’s regulatory reports filed throughout the transition period.¹⁵

The uncertainty of future government initiatives and their possible effect on the securitization market was a key factor in providing an optional implementation period in the Final Rule. The Agencies realize securitization is an important source of funding for





many banking organizations, and at this time they are uncertain of the possible effects legislative or regulatory changes could have on securitization activities. The timing of the transition period discussed above also intentionally correlates with the termination dates of government programs supporting the securitization market (e.g., the non-commercial mortgage-backed securities portion of the Term Asset-Backed Securities Loan Facility). Although there is risk in not knowing what the future holds, the implementation delay provides time for observation of the effects of FAS 166 and FAS 167 on bank lending and the financial markets. The transition mechanism is optional as it requires a banking organization to maintain two sets of records during the course of the implementation delay. One set of records will account for affected VIEs for financial reporting under GAAP, while the other will help track the exposure of all VIEs affected by FAS 166 and FAS 167 and the ALLL attributable to their assets.

Taking into consideration the effects implementing FAS 166 and FAS 167 may have on allowance for loan and lease losses (ALLL), the Final Rule states during the exclusion period (first two-quarters following the implementation date), a banking organization may include its total ALLL without limit in Tier 2 capital as long as the full amount of ALLL is attributable to those assets excluded from RWA during the exclusion period (referred to as the “inclusion amount”). During the phase-in period (third and fourth quarters following the implementation date), a banking organization may include 50 percent of the inclusion amount in tier 2 capital. Any ALLL in excess of 50 percent may be included in tier 2 capital but will be subject to the 1.25 percent limit set forth by the Agencies.¹⁶ Any ALLL linked to a VIE which has received implicit support will also be subject to the 1.25 percent limit.

Prior to the Final Rule, the risk-based capital rules permitted a banking organization to exclude from RWA the assets of an ABCP program it is required to consolidate under GAAP. However, after reviewing comments submitted following the August 2009 NPR, the Agencies decided to eliminate the ABCP exclusion due to concerns around regulatory capital arbitrage and implicit support. The elimination of the ABCP exclusion does not apply to the exclusion or phase-in periods described above, in which case the exclusion of assets of an ABCP program meeting certain requirements is permissible. The Agencies have also decided to incorporate in the risk-based capital

rules the reservation of authority allowing a banking organization’s primary federal supervisor to require a banking organization to treat an off-balance sheet VIE as if it were consolidated onto the banking organization’s balance sheet. The Agencies believe this authority will help address instances where a banking organization structures a transaction(s) as to avoid consolidation under FAS 167.

Although the Agencies believe the effects of FAS 166 and FAS 167 on risk-based capital ratios will better reflect a banking organization’s credit risk, many commenters expressed concern around the decrease in volume and increase in cost of lending to consumers and businesses. In the Final Rule, the Agencies note risk-based and leverage capital ratios will likely decrease for those banking organization’s affected by the implementation of FAS 166 and FAS 167. Through research based on public and supervisory information, it has been determined risk-based and leverage capital ratios will remain considerably above regulatory minimums for the largest banking organizations, with smaller banking organizations not being largely affected.

The Agencies do not believe banking organizations will need to raise substantial capital or decrease lending as a result of implementing FAS 166 and FAS 167, but rather believe this implementation will better capture credit risk and prove to be an important factor in providing a safe and sound banking environment. Comptroller of the Currency John C. Dugan was quoted in a March 1, 2010 *News Release* stating, “We simply have to make the financial system more resilient to future shocks, which means we cannot let the mere possibility of reduced credit availability in the future thwart our efforts for change.” “The issue should not be *whether* we strengthen the system, but instead, *how much* we do so, and *how quickly* we do so, given the credit tradeoffs we face.”¹⁷

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End Notes

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- ⁸ <http://www.occ.gov/ftp/release/2010-27a.pdf>
- ⁹ This document contains 17 principles detailing international supervisory guidance for sound liquidity risk management. <http://www.bis.org/publ/bcbs144.pdf>
- ¹⁰ <http://www.occ.gov/ftp/release/2010-27.htm>
- ¹¹ <http://www.occ.gov/ftp/bulletin/2010-11a.pdf>
- ¹² Ibid.
- ¹³ <http://www.fdic.gov/news/news/press/2010/pr10012a.pdf>
- ¹⁴ <http://www.fdic.gov/news/board/aug26no6.pdf>
- ¹⁵ For banks, Schedule RC-R of the Call Report; for savings associations, Schedule CRR of the TFR; and for banking holding companies, Schedule HC-R of the FR Y-9C.
- ¹⁶ The amount of ALLL that may be included in the Tier 2 capital is limited to 1.25 percent of gross risk-weighted assets under the risk-based capital rules
- ¹⁷ <http://occ.gov/ftp/release/2010-26.htm>

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