Why a compliance knowledge center is the best approach for addressing the Dodd-Frank regulatory deluge

Prepared by:

Tyrone Beasley, Principal, Risk Advisory Services, RSM US LLP
tyrone.beasley@rsmus.com, +1 972 764 7100

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) went into effect July 21, 2010. The resulting tsunami of regulatory changes is placing tremendous strain on the compliance functions of banks and nonbanks alike. Adapting to and succeeding in this heightened and continually evolving regulatory environment requires that entities do more than simply ramp up existing compliance practices to handle this ongoing deluge of information. It requires that they rethink their compliance approach from top to bottom. Those that are most successful will be those that adopt a knowledge center approach. The Consumer Financial Protection Bureau (CFPB) began its bank supervision program in July 2011, and launched its nonbank supervision program in January 2012. The CFPB believes the importance of nonbanks has grown substantially in the market of consumer financial products and services and aims to ensure that banks and nonbanks play by the same rules with consumer protection as the focal point. Seeing that nonbanks have not historically been examined by federal regulators, the need to understand the ramifications of the Dodd-Frank Act and how to approach the regulatory onslaught is enhanced.

To understand why, you must first fully appreciate the scope of the regulatory change that Dodd-Frank represents. Drafted as a response to perceived abuses and regulatory shortcomings exposed during the financial crisis that began in the mortgage industry in 2007, Dodd-Frank's 16 provisions affect virtually every aspect of operations for banks and nonbanks. A quick review of the 16 titles contained in the act make this clear:

- Title I — Financial Stability
- Title II — Orderly Liquidation Authority
- Title III — Transfer of Powers to the Comptroller, the Federal Deposit Insurance Corporation, and the Federal Reserve
- Title IV — Regulation of Advisors to Hedge Fund and Others
- Title V — Insurance
- Title VI — Improvements to Regulation
- Title VII — Wall Street Transparency and Accountability
- Title VIII — Payment, Clearing and Settlement Supervision
- Title IX — Investor Protections and Improvements to the Regulation of Securities
- Title X — Bureau of Consumer Financial Protection
- Title XI — Federal Reserve System Provisions
- Title XII — Improving Access to Mainstream Financial Institutions
- Title XIII — Pay it Back Act
- Title XIV — Mortgage Reform and Anti-Predatory Lending Act
- Title XV — Miscellaneous Provisions
- Title XVI — Contracts

Dodd-Frank is more than more of the same

Some of the provisions of Dodd-Frank are already in force, but the act is the proverbial pig in the regulatory python. Much of it still has to be digested and translated into specific requirements by the various agencies charged with its enforcement. The strain financial institutions are already feeling as the regulatory fallout from Dodd-Frank continues is just the beginning, and nonbank entities are starting to feel the strain as well as they adapt to a regulatory oversight environment marked with uncertainty.

Compare this regulatory load to that most banks and nonbanks were used to. Prior to Dodd-Frank, most financial institutions and nonbank entities dealt with perhaps one significant regulatory change each year. Now, the CFPB and other regulatory agencies are issuing new and far-reaching changes on a quarterly, or even monthly basis — and the changes that many of these regulations require demand not only functional changes to oversight, but strategic analysis of everything from operations to product offerings to compensation and staffing practices. They affect all aspects of day-to-day operations, including deposit operations, commercial and consumer lending, debt collection activities, back room functions and even third-party relationships. The increased cost of compliance due to Dodd-Frank and the compliance management expectations of the CFPB must be considered when deciding on new products and services, additional branch locations and other expansion plans, such as mergers and acquisitions.

And these changes are being implemented on an aggressive schedule. Public comment periods — the time given to consumer groups, businesses and others affected by the regulations — to provide input are shorter than those allowed for previous regulatory changes. As a result, compliance departments and senior management have insufficient time to understand all the ramifications of each change. While the requirements may be understood at a high level, there are often numerous subrequirements that are not considered until the effective date of a new regulation approaches. By then, it is too late for an institution's compliance personnel to effectively advise senior management on an appropriate implementation approach.

Because of the far-reaching nature of these changes, however, execution of an implementation plan is not the only — or in some cases even the most important — concern. Often, the board and senior management need to consider strategic changes required by new regulations, such as resource investment, product development and changes to service offerings.

Why a compliance knowledge center is the best approach

Given the time required for effective strategic and operational responses to these sweeping regulatory changes, the passive approach of waiting for the changes to occur before considering implementation options is no longer enough. A compliance knowledge center offers entities the best option for responding to Dodd-Frank and the expectations of the CFPB. This approach allows entities to establish a proactive compliance framework that keeps them ahead of the regulatory curve. A compliance knowledge center driven approach will:

- Take a holistic view across the entire flow of incoming and anticipated regulatory changes
- Position the entity to provide timely and effective input during the now-shorter public comment periods
- Inform senior management and the board on the effects of regulatory change across the organization, including not just compliance practices, but also with respect to revenues and profitability, resource commitments, technology, and products and services
- Provide senior management with an estimate of compliance costs
- Help senior management develop understandable and actionable compliance policies and procedures for all affected operations
- Help senior management understand and document the impact on the entity's overall current risk assessment

Compliance knowledge center functionality

The makeup of the compliance knowledge center will be driven by the size and complexity of each entity. Housing the knowledge center in the compliance department is a practical, cost-efficient model. This formalizes the compliance department's ability to dissect the flow of regulatory information for senior management's use. The knowledge center's examination of proposed rules should address the:

- Applicability of the rules to the entity, and if pertinent, the departments, products and services affected by its implementation
- Effects on information technology applications and the need, if any, for technological investments
- Projected financial impact of implementing the new rule, including revenue, expense and profit considerations and resource investments
- Identification of control gaps in complying with new rules

By establishing formal roles and procedures for proactively analyzing new regulations and their effects, the compliance knowledge center can minimize the overwhelming effect that Dodd-Frank provisions have on the organization as a whole.

Example: The lender's compensation rules issued through Title XIV – Mortgage Reform and Anti-Predatory Lending Act.

The rule limits the avenues of compensation for mortgage originators and establishes prohibitions for income generated from mortgage loans. This rule has had a profound impact on the mortgage industry in general and mortgage loan officers, specifically. However, many entities did not understand the overarching, short- and long-term effects the rule would have on resources, products and services, and compliance risk. For example, as a result of these rules, many mortgage loan originators left their jobs and a variety of loan products had to be eliminated. Many entities did not anticipate these ramifications, forcing them to scramble to deal with staffing issues and outdated loan product portfolios. An entity with a compliance knowledge center in place could have anticipated these issues, and made proactive recommendations not only on compliance with the regulations, but on the operational fallout, as well.

The role of the compliance knowledge center is to educate senior management on the effects of regulatory changes and to help affected departmental managers and personnel prepare for process and procedural changes needed as a result. This role requires a more engaged compliance department. It requires department leaders who understand the risk inherent in specific regulatory requirements, how the risk applies to the entity, and the operational and strategic importance of communicating the right information to the right people.

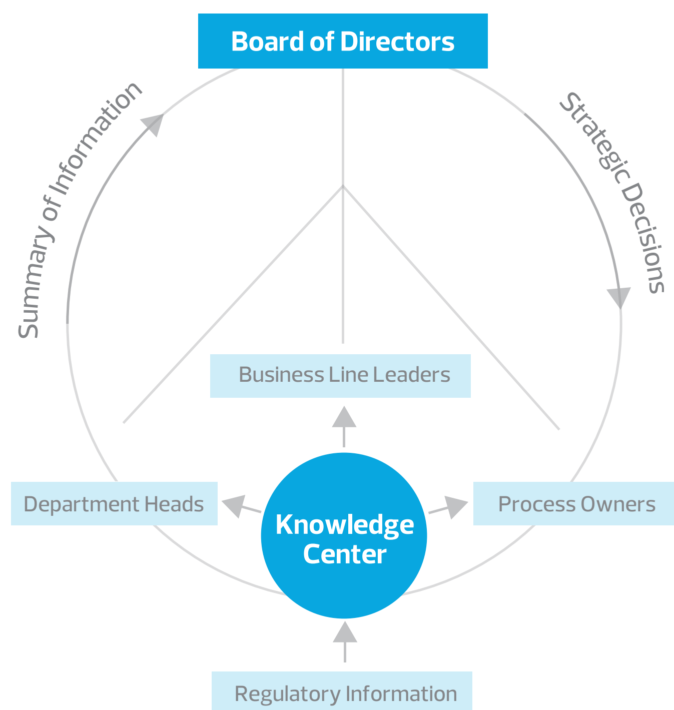
Organization-wide communications channel

Managing the flow of regulatory information is crucial to an effective response to Dodd-Frank provisions. Entities have already been swamped with Dodd-Frank information, but that is just the beginning. Hundreds of proposed rules, new regulations, revised regulations, guidance documents and regulatory issuances have arrived and will continue to arrive over the next year or two. Timely communication of the right information to the right people will be a vital role for an effective compliance knowledge center.

The goal will be to digest incoming regulatory data and disseminate it with the appropriate level of analysis and at the appropriate level of detail, so that recipients at all levels of the organization, from the board and senior management to operating managers at all levels, will have all the information they require, without being drowned in information that they do not need.

The communications channel will need to be interactive. Decisions on the effects that regulatory changes will have on an entity cannot be made in a vacuum. Financial stakeholders at the ownership and board levels, and internal stakeholders with day-to-day responsibilities in all affected areas of operations, should all be consulted on the effects of Dodd-Frank provisions.

Given these robust communications requirements, the usual stream of emails containing brief descriptions and attachments for readers to decipher on their own will no longer suffice. Rather, the communications channel must effectively relay information and manage feedback to allow for effective decisions on policies, procedures, products and services.



Example: Credit score disclosures

The Federal Reserve and Federal Trade Commission issued joint final rules to implement Dodd-Frank provisions requiring creditors to disclose credit scores and related information to consumers in risk-based pricing and adverse action notices on July 6, 2011. The knowledge center, instead of communicating the requirements after final rules were established and an effective date for implementation was published, would have followed the developments of the rules in real time, while identifying affected business lines and department heads. The potential impact of the rules would have been investigated prior to final issuance to include financial, operational, reputational, market and legal risk.

Compliance department leadership and structure

Because the response to Dodd-Frank requires an approach to compliance that is different in both scope and kind, it is also time for entities to carefully consider the leadership and structure of their overall compliance effort. Simply stacking more resources under the management of your existing compliance manager may not be the best response.

Effective response to Dodd-Frank requires a strategic approach — and that will require a compliance function leader who not only understands the incoming regulatory requirements, but who has a sufficient understanding of your entity's markets, operations, products and services to grasp not only the compliance requirements, but the strategic ramifications of new regulatory demands. This leader will need to be able to communicate effectively with everyone from your board and senior management to operational managers across your organization.

Demands on your compliance function will not only be higher for the foreseeable future, they will also be less predictable. As the numerous provisions of Dodd-Frank are analyzed and the resulting regulations promulgated, compliance demands will likely wax and wane. Therefore, entities will need to consider the best approach to ensuring sufficient scalability in their compliance response to meet demand without burdening your organization with underutilized resources during periods of lower demand. This may well require a mixture of dedicated, strategically focused in-house resources with outside resources that can assist, as necessary, with execution.

Risk management is defined as the process of measuring or assessing the actual or potential dangers of a particular situation. A compliance knowledge center approach to the exploding regulatory demands generated by Dodd-Frank is the best way for entities to manage the risks created by this far-reaching legislation.

+1 800 274 3978
www.rsmus.com

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