Dodd-Frank Stimulates Financial Industry Transformation – Again!
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Here we go again! From the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) of 1989, Gramm-Leach-Bliley Act (GLBA) enacted in 1999, to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, we’ve seen a trend of regulatory overhaul in each of the last three decades.

Regulatory change is not new to the industry, but the sheer scale and scope of reform today is unprecedented.

**Industry Transformation, Again!**

We’re just starting to experience the aftermath of Dodd-Frank and watch with a wary eye for what’s still to come in the rule-making years of 2011 and beyond. Call it a maze, tsunami, or storm of new financial regulations, but the bottom line is that every financial institution is facing a compliance challenge to address and prepare for right now. These new compliance mandates affect consumer financial products and services, income, operating expenses, and risk management throughout the institution.
Dodd-Frank’s Effect on Financial Institutions

Leaders of financial institutions will be accountable for understanding and complying with over 23,000 pages of regulatory change from Dodd-Frank. It’s a huge undertaking to ascertain the true effect on customers, products, services, and day-to-day operations. The number of changing regulations will require a forest of trees to print; but how many new rules, directly affecting the institution, will be put forth in the next 12 to 18 months?

An estimated 214 new or changing regulations will trickle down from Dodd-Frank. Approximately 194 regulatory updates and 20 “new” rules will directly affect financial institutions. Whether the number is 214, 194 or 20, it is still a massive undertaking for bank and credit union leaders to address. Additionally, these new compliance readiness demands must be added to the work required from the dozen or so regulatory updates that happen each year already.

How does the institution’s management team even begin to assess, identify, and take action on the steps required to comply with new mandates? At the foundation of preparedness is the need to update and streamline the existing way of doing things—including programs, services, software, data normalization, and technology—in order to adapt and survive.

This article outlines key areas of regulatory change that are in process and highlights how IT infrastructure must be transformed to adapt. It also presents a best practices view to assist in beginning the journey of transforming IT infrastructures to successfully ride the wave of regulatory reform.
Key Areas of Transformation

Financial institutions should pay close attention to the rules and statements that come from the regulatory banking agencies and newly created Consumer Financial Protection Bureau (CFPB) regarding the following key categories of reform:

- Capital adequacy
- Mortgages
- Liquidity
- Stress testing
- Other considerations

All of the new compliance mandates will affect consumer financial products and services, and risk management throughout the institution. They will require institutions to collect, analyze and report more detailed data to consumers, management, auditors, and regulators.

Institutions can more easily begin to identify and plan for this regulatory wave by breaking the elements down into the above five categories. This will enable a better, less overwhelming approach to management that will help assign resources, assess the effects on existing operations and practices, and execute strategy.

Capital Adequacy

The Dodd-Frank Act requires financial institutions to raise the quality, consistency, and transparency of capital in order to ensure that the banking industry is able to absorb losses. All institutions will be required to hold additional capital. Due to the difficulty involved with raising new capital, many institutions are meeting the new ratio requirements by adjusting balance sheets, thus reducing net income during a time when high costs, weak spreads, and lower fees are a reality.

The Federal Reserve Board (FRB), Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) adopted a final rule that establishes a floor for the risk-based capital requirements applicable to the largest, internationally active banking organizations. The rule is consistent with the requirements of Section 171 of the Dodd-Frank Act. In addition, it authorizes the FFIEC to impose a 15-1 leverage requirement on a company if necessary to mitigate a grave threat to the financial system. It also mandates changes to make capital requirements countercyclical. This means that during downturns, banks would be in a better position to absorb increased losses while sustaining lending to support economic growth.

The Collins Amendment (i.e., Section 171), will drive significant changes in how capital is accumulated for all institutions. However, it remains to be seen how much more capital regulators will require with the new countercyclical policy. Every bank, regardless of size, should have a Capital Plan and a Capital Contingency Plan in place if additional capital is needed.
Dodd-Frank also tightens the capital standards for bank holding companies by placing limits on trust preferred securities. Institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009, may continue to include preferred securities that were issued prior to May 19, 2010. Further, depository institutions with more than $15 billion in total consolidated assets will be required to phase-out – over a period of three years – trust preferred securities issued before May 19, 2010 that are presently included in regulatory capital.

Mortgages

New regulations on mortgage originators, and new disclosure requirements as a result of amending the Truth in Lending Act, amplify the compliance reporting and documentation requirements for financial institutions. The new amendment restricts the provision of incentives for steering consumers into higher-cost mortgage loans, and sets minimum underwriting standards. The act also increases the amount of information that financial institutions will need to report in accordance with the Home Mortgage Disclosure Act of 1975 (HMDA).

Overall, the mortgage reform changes alone will impose a significant effect on operations. Dodd-Frank specifies that institutions must prohibit:

- Mortgage originators from steering a consumer to a residential mortgage loan that the consumer lacks a reasonable ability to repay or has predatory characteristics.
- Steering a consumer from a qualified mortgage which the consumer is qualified to a non-qualified mortgage.
- Abusive or unfair lending practices that promote disparities among consumers of equal credit-worthiness but of different race, ethnicity, gender, or age.
- Mortgage originators from mischaracterizing credit history of a consumer, mischaracterizing the appraised value of the property, or discouraging a consumer from seeking a loan from another mortgage originator.

Liquidity

Funds management and proper liquidity planning is essential to all institutions to compensate for expected and unexpected balance sheet fluctuations. The risk of not being able to obtain funds at a reasonable price within a reasonable time period to meet obligations as they become due, could affect the ongoing viability of an institution. Regulatory agencies have stated that many financial institutions need to improve liquidity policies and contingency funding plans as part of the overall asset and liability management function. For example, monitoring ratios are many times limited to a static analysis and only provide a point-in-time snapshot of the liquidity position. A near real-time comprehensive liquidity program is necessary.
Stress Testing

The regulatory agencies emphasize the importance of stress testing as a tool for assessing risk and addressing a range of potential adverse outcomes.

Stress testing is an important aspect of Dodd-Frank. Stress testing requirements for interest rate risk (IRR) and for other variables on commercial loan portfolios are now required. Institutions must now assess liquidity and sustained operations under “worst case” conditions. These conditions may include downgrades in asset quality, depleted capital, net reductions in deposit balances, or loss of funding support. Financial institutions are called upon to use stress testing to evaluate risk of assets and funding concentrations.

Other Considerations

There are other provisions that will challenge the need to establish real-time visibility, analysis and reporting of enterprise-wide data. These include:

- A loss of interchange fee income under the Durbin amendment. Institutions are looking for alternative sources of income such as bundling of products, increased account servicing fees, charging fees for previously free services, and many more.

- New disclosure and reporting requirements. The CFPB carries the authority to require disclosures to ensure that customers understand the “costs, benefits and risks associated with the product.” It also mandates 20 new HMDA reporting obligations.

- Providing proof to CFPB that banks are offering fair, equitable and non-discriminatory access to credit for customers.

Transforming the IT Infrastructure is key to Compliance and Success

All of these new and updated regulatory requirements will require institutions to transform their IT infrastructure to update and streamline the existing way of doing things in order to adapt and profit in this new environment.

Banks cannot take a “wait and see” approach in identifying how the Dodd-Frank Act will affect IT operations. There is much to evaluate and prepare. Rather than reacting on a rule-by-rule basis, institutions must formulate a well-coordinated plan to transform the IT infrastructure and its operations to provide the visibility, analytics, and reporting that is required to facilitate compliance.

The right IT infrastructure can enable an institution to drive down the time and cost of compliance efforts, while expanding resources, expertise, intelligence, and real-time visibility across the enterprise.

To ensure compliance, financial institutions require an IT infrastructure that will normalize data to enable:
• A logical data model based on deep domain experience
• End-use driven and pre-defined physical data model for sourcing and provisioning, ready for immediate deployment and use across the enterprise
• A unified and conformed reporting data model to provide fast query performance across all functional domains
• Shared data, metadata, computations, calculations, business rules and controlled access that enable organizations to meet emerging or changing cross-functional business and regulatory mandates quickly and with reduced expense
• Thousands of pre-built data quality checks contextualized to the institution’s analytical end use that enable financial institutions to eliminate accuracy and consistency issues
• A formal and centralized general ledger reconciliation process, for accurate and fully-auditable reporting that eliminates inconsistencies across ledgers, books and marts
• The capability to handle high volume, “what-if” computations across business domains to support enterprise level stress testing and scenario analysis
• Analytical applications that can combine results from multiple business areas to easily and securely support cross-functional analytics throughout the enterprise
• A “self-service” business intelligence environment with all key business dimensions and vocabulary pre-built to help users get answers quickly and efficiently
• Fast query response when performing time sensitive ad-hoc analytics and reporting
• Consolidation of data across business lines to help reduce IT footprint and total cost of ownership

With the right solutions, financial institutions can convert these new compliance mandates into a plethora of benefits, such as:
• Automation and streamlining of analytical processes
• Strong compliance posture and consistent operations at an “examination ready” state
• Real-time visibility and intelligence across the enterprise
• Continuous compliance and risk management

A Best Practices Approach: Four Steps to Get Started

There are many operational challenges to consider, while managing and maintaining day-to-day activities. As such, many institutions are left struggling with how to begin. Table 1 includes four steps financial institutions need to consider when beginning an IT transformation initiative.

Creating and implementing an IT transformation initiative to help meet regulatory compliance can be a daunting proposition. However, financial firms can get started with four steps:
• Obtain IT transformation expertise and resources. Financial firms must identify internal personnel with the experience, skills and time necessary to plan and manage the transformation, hire more staff or turn to a third-party outsourcing relationship for the needed expertise.

• Firms must define their IT transformation strategy, garnering support from management. The strategy must include a balanced allocation of funding for personnel and tools.

• Financial organizations must implement an automated and intelligent real-time analytical infrastructure. This should consist of a business intelligence platform, analytical computations and a unified financial services model.

• Organizations must establish a baseline for data and anticipated activity. Dodd-Frank requires institutions to enable their businesses to perform complex what-if scenarios and enterprise-level analytics. Banks must be able to simultaneously provide fast query response for time-sensitive ad hoc analytics and reporting, and also to cut operating costs by combining silo’d functional warehouses across business lines. This can be accomplished by centralizing all relevant data to empower the organization’s personnel to efficiently enter information or automatically gather the information and then store it in a database for high-performance data warehousing and online transaction processing.

Financial services organizations must be proactive in taking steps to comply with regulatory mandates. A sensible, comprehensive approach to industry and government mandates gives banks the opportunity to transform their IT infrastructure, improving not only regulatory compliance, but also operational efficiency and competitive positioning.
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Author: Rohit Verma
Senior Director, Product Management and Strategy
Oracle Financial Services Software
Oracle Corporation
World Headquarters
500 Oracle Parkway
Redwood Shores, CA 94065
U.S.A.

Worldwide Inquiries:
Phone: +1.650.506.7000
Fax: +1.650.506.7200
oracle.com

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