Banking Issues

Insights into the trends shaping our industry*

Fall 2005

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Welcome to the Fall 2005 edition of PwC's Banking Issues, where we bring you insights into the trends shaping our industry. This issue focuses on key challenges facing the banking and consumer finance industry, which are organized into three sections: SEC Update: Sarbanes-Oxley & Regulation AB; Technical Accounting; and Regulatory.

Each section contains articles written by subject matter specialists from PricewaterhouseCoopers' Banking Industry practice. Our objective is to provide you with fresh perspectives and analysis of recent industry and regulatory developments. Because each author is a specialist in his or her respective discipline, I encourage you to contact them with questions you may have about a particular or related topic.

We are committed to helping you stay abreast of industry trends, public reporting requirements, and regulatory changes. On behalf of our Banking Industry Practice, we hope that you find Banking Issues to be insightful.

Best regards,

William J. Lewis
PricewaterhouseCoopers LLP
U.S. Banking Industry, Practice Leader

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Building a more efficient 404 process

By Rick A. Moyer

Top-ten list

1. Changing a project to a process
2. Begin by testing company-level controls
3. Consultations with external auditors
4. Insufficient accounting and finance resources
5. Management estimates
6. Accounting for income taxes
7. Complex and/or non-routine transactions
8. Annual review of accounting policies
9. Compensating controls
10. Auditor for a day

With the first year of Sarbanes-Oxley's Section 404 now behind us, it is a good time to assess how far we have come and focus on the road ahead. In Year One, registrants expended a great deal of effort to become 404 compliant and, along the way, patched a number of potholes in the road. For Year Two, business leaders are asking the strategic question — "How can I achieve the benefits of 404 while minimizing the effort spent to achieve those benefits?" The following "Top-Ten List" serves as a guide for management teams to begin to answer this critical question.

1. Changing a project to a process – In the first year, companies used an "all hands on deck" approach to prepare for 404. Alternatively, a process-based approach with the documenting and testing of controls embedded into everyday activities will help create a more sustainable 404 process. This will involve including 404 considerations in the change management process going forward. When significant changes are made to the business, management will need to assess the impact on the existing internal control environment and disclose any changes that they believe could have a material impact on that environment.

2. Begin by testing company-level controls – Company-level controls, such as establishing a strong tone at the top and ensuring a strong period-end financial reporting process, have a pervasive impact on internal control over financial reporting. By obtaining evidence early in the process that these pervasive controls are working effectively, management will have more opportunity to alter the nature, timing, and extent of testing required at the process level.

3. Consultations with external auditors – There is a clear recognition that consultations with external auditors have become unnecessarily stressed due to 404 and that the inability of management and external auditors to openly discuss complex accounting issues does not facilitate high quality financial reporting. Management teams and auditors need to work together and communicate continually during accounting consultations to ensure all views are thoughtfully analyzed. After the consultation is complete, management teams should evaluate all the information they obtained and make their final determination of the accounting to be applied.

4. Insufficient accounting and finance resources – One of the root causes of many material weaknesses was the inadequacy of knowledge of generally accepted accounting principles ("GAAP") by accounting and finance staff. Ensuring the complement of accounting and finance resources is commensurate with the company's financial reporting responsibilities is an important step in evaluating the design and operating effectiveness of company-level controls.

5. Management estimates – Management estimates inherent in the financial reporting process, such as the allowance for loan and lease losses and fair values of financial assets where a market value is not readily available, have historically been a high risk area in preparing the financial statements of financial institutions. Strong controls around the information flow and assumptions used

in the estimation process will minimize the risk of major control failures going forward.

6. Accounting for income taxes – In the first year of 404, many companies reported material weaknesses related to controls over income tax accounting. To strengthen these controls, a fresh focus on the tax process may be necessary. Focusing on the reconciliation of deferred tax assets and liabilities to the underlying accounting records, as well as ensuring non-routine transactions are given the appropriate tax specialist attention will reduce the risk in this area.

7. Complex and/or non-routine transactions – Many companies reported material weaknesses related to ineffective controls over the selection and application of GAAP to complex and/or non-routine transactions. To properly apply GAAP to such transactions, management should have the following in place: 1) a process for identifying all complex and/or non-routine transactions, 2) a process for communicating these transactions to those responsible for determining the proper accounting, 3) a process for identifying applicable GAAP, and 4) a complement of personnel with sufficient knowledge of GAAP to record transactions properly.

8. Annual review of accounting policies – A number of companies restated their financial statements for discrepancies between their lease accounting policies and the accounting mandated by GAAP. A thorough comparison of company accounting policies and procedures to those required by GAAP is essential to prevent future restatements and material weaknesses. This effort may be time consuming if such a review has not been conducted for a period of time. To be effective, this review should be performed by personnel with a comprehensive knowledge of GAAP.

9. Compensating controls – Compensating controls are defined as controls that reduce or "cap" the financial statement exposure of an identified control deficiency. In Year One, many companies looked to management analytical procedures to serve as compensating controls. Management teams and auditors should work together early in the 404 process to gain an understanding of the level of precision at which these controls operate and ensure that it is sufficient to prevent a material misstatement of the financial statements.

10. Auditor for a day – To meet the documentation and testing requirements of 404, many companies made operational personnel "auditors for a day". To assist line management in becoming stronger at identifying and testing key controls, companies may wish to hold training sessions and/or maintain a 404 support team to field questions arising from line management testing.

By focusing on the areas identified above and maintaining ongoing communication with external auditors, management teams can take a significant step forward in maximizing the benefits of 404 and reducing the effort required to achieve those benefits.

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Understanding Regulation AB

by Mike Seelig, David M. Lukach & Thomas Knox

The registration, disclosure, and reporting requirements for publicly issued asset-backed securities (ABS) are governed by the Securities Act of 1933 and the Exchange Act of 1934.[1] The modern asset-backed securitization market did not exist at the time of the creation of these laws, and as a result, the process of asset-backed security registration has been revised several times by Congress and the Securities and Exchange Commission (SEC) to better reflect the needs of the ABS market.

On December 22, 2004, the SEC published final regulations, labeled "Regulation AB[2]", that, among other things, consolidate and codify existing interpretative, primarily client-specific positions that clarify the Securities Act registration requirements for asset-backed securities offerings. We will highlight the three key changes required by this new regulation:

1. Changes to the required disclosures associated with the securities registration process
2. Changes to the Exchange Act reporting requirements for ABS
3. A new annual servicing assertion and accountant's attestation report

Transition timeline

Only those securitizations that meet the definition of "Asset-Backed Security" issued through the SEC registration process (S-1 and S-3) are covered by Regulation AB. Therefore, privately issued securitizations are not subject to the regulation.

All public asset-backed issuances commencing after December 31, 2005 will be subject to the new regulatory requirements. Those issuances commencing on or prior to December 31, 2005 will be grandfathered in their entirety. Nearly all issuers will need to file amendments to their outstanding registration statements, ensuring compliance for takedowns after December 31, 2005 under the new rules. In some cases, registrants will have a grace period extending through the first quarter of 2006.

Assuming ABS registrants file on a calendar year basis, the first 10-K filed under the new rules would be due no later than March 2007. However, master trusts not filing on a calendar year basis may be subject to the new rules as early as March 2006. The new monthly report, Form 10-D, will be required to be filed as early as January 2006.

New disclosure regulations for ABS securities

The new Form S-3 instructions for ABS, as described in "Regulation AB[2]", specify incremental information that must be reported in the registration documents. Issuers will need to determine which information is applicable and material for each offering.

Perhaps one of the most significant of the new requirements is the static pool analysis. The static pool information presents the performance for specific types of assets originated at different points in time. By comparing the performance of originations at similar points in the asset life cycle, investors can evaluate trends or patterns

[1] PricewaterhouseCoopers has prepared this article regarding Regulation AB in order to provide a framework for a general understanding to a user of such information. PricewaterhouseCoopers does not practice law, and is not in this article interpreting the requirements of the U.S. securities law and regulations or providing legal advice. Readers should seek advice from legal counsel with regard to any matters of law related to the preparation or understanding of information related to Regulation AB

[2] Securities Act Release No. 8518 (Dec. 22, 2004) [70 FR 1506] (the "ABS Adopting Release"), available on the Web at http://sec.gov/rules/final/33-8518fr.pdf

that may not be apparent from overall portfolio data.

The SEC believes that investors will benefit from static pool data regarding delinquency and loss history critical information in evaluating their investment in asset-backed securities. The new SEC regulations require disclosure of static pool data if material to the transaction.

In general, static pool data will be required with respect to the delinquency and loss experience of the sponsor's overall portfolio, or from prior securitized deals, for the past five years, or a shorter period when appropriate. The data should be presented in increments, monthly or quarterly, that are material or significant to the asset type being securitized.

Given the enormous amount of historical data for which disclosure may now be necessary, the SEC will provide issuers with the option of posting static pool data on a web site rather than including it in the prospectus. The process of finding, capturing, reviewing and reporting static pool data will be a challenge for even the largest of ABS sponsors.

Changes to the Exchange Act reporting requirements

Under the existing reporting system, periodic distribution and pool performance information is generally filed on Form 8-K in lieu of filing quarterly reports on Form 10-Q. However, investors are not able to easily distinguish these Form 8-K reports from other reporting on Form 8-K, such as the reporting of extraordinary events or the filing of transaction agreements.

The SEC is adopting a new Form 10-D, to act as the report for the periodic distribution and pool performance information. Every asset-backed issuer subject to Exchange Act reporting requirements will have to make such reports on Form 10-D and to file the report within 15 days after each required distribution date. A report will be necessary regardless of whether the required distribution was actually made or whether a distribution report was in fact prepared or delivered under the governing documents.

With Form 10-D, issuers must provide information required by Item 1121 of Regulation AB and attach as an exhibit to Form 10-D the distribution report delivered to the trustee or security holders. The stated expectation is that all or most of the distribution and pool performance information required by Item 1121 will be included in the distribution report. If all of the required information is not in the distribution report, the missing information must be provided in the Form 10-D itself.

The final regulations add a separate general instruction to Form 10-K – Instruction J – to specify how the form is to be used with respect to ABS. Key changes include a specific Sarbanes-Oxley 302 certification and a statement of compliance with the applicable servicing criteria (defined in Regulation AB) from all parties participating in the servicing function.

The final regulations are specific and limiting with respect to who is permitted to sign ABS Exchange Act reports. For Forms 10-D and 8-K, the report must be signed by the depositor. "In the alternative," however, the report may be signed on behalf of the issuing entity by a duly authorized representative of the servicer. With respect to Form 10-K, such annual reports must be signed either (i) on behalf of the depositor by the senior offi-

Regulation AB—at a glance:

Updates and clarifies the Securities Act registration requirements for Asset Backed Securities ("ABS") offerings

Consolidates existing positions that allow modified Exchange Act reporting that is more relevant to ABS

Provides disclosure guidance and requirements for Securities Act and Exchange Act filings involving ABS

Establishes a consistent servicing standard that is used as the basis for measuring the performance of each party participating in servicing activities

Requires an accountant's attestation report for each servicer assertion

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cer in charge of securitization of the depositor or (ii) on behalf of the issuing entity by the senior officer in charge of the servicing function of the servicer.

Servicers and depositors have already begun to analyze the additional information that will need to be reported on Forms 10-D and 10-K. The new forms will require changes to both information systems as well as the processes by which organizations gather and report the required information.

The annual servicing assertion and accountant's attestation report

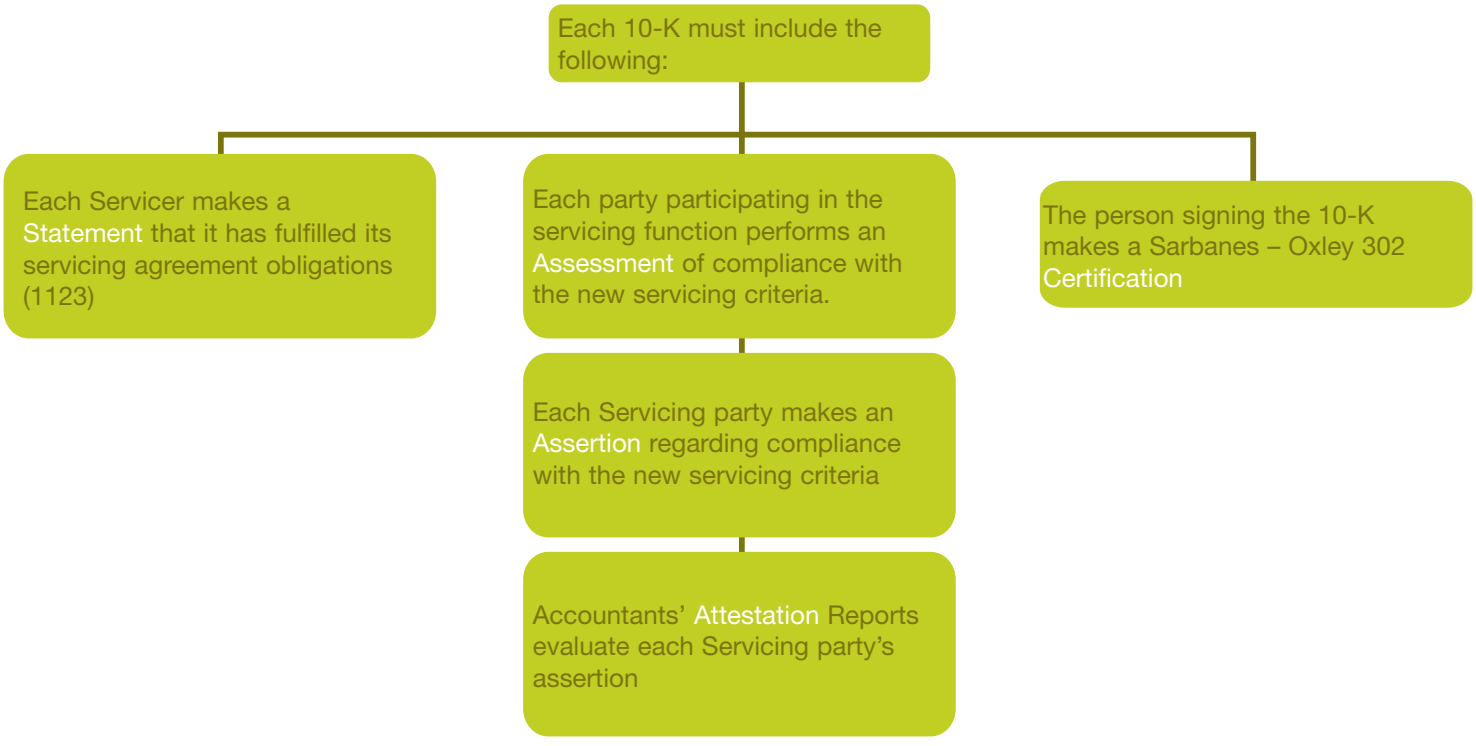
A servicer assessment report will be required from each party participating in the servicing function of an ABS, containing the following:

1. A statement of the party's responsibility for assessing compliance with the servicing criteria applicable to it.
2. A statement that the party used the servicing criteria (as defined in 1122 of Regulation AB) to assess compliance with the applicable servicing criteria.
3. The party's assessment of compliance with the applicable servicing criteria as of and for the period ending at the end of the fiscal year covered by the Form 10-K report. The report must include disclosure of any material instance of non-compliance identified by the party.
4. A statement that a registered public accounting firm has issued an attestation report on the party's assessment of compliance with the applicable servicing criteria as of and for the period ending at the end of the fiscal year covered by the report on Form 10-K.

The report is to include an assessment of the servicing function as of the end of, and for a full fiscal period (or the applicable partial period in the case of the initial report), rather than at a single point in time. Also, servicing compliance is to be determined at a "platform" level, rather than at a transaction-specific level. This platform level reporting approach assumes that the asserting party will assess compliance with respect to all ABS transactions involving such party that is backed by assets of the type backing the ABS covered by the Form 10-K report.

A new "Attestation report on assessment of compliance with servicing criteria for asset-backed securities" in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning an asserting party's assessment of compliance with servicing criteria, will be required under the Regulation and in accordance with standards on attestation engagements issued or adopted by the Public Company Accounting Oversight Board. (AT § 601).

The report issued by the registered public accounting firm must be available for general use and not contain restricted use language. The SEC believes that the servicing criteria adopted as part of Item 1122 of Regulation AB are suitable criteria, as that term is defined in the SSAE No. 10, and are available to enable a



registered public accounting firm to issue a report on a party's assertion without restricted use language. These procedures will largely be incremental to procedures often performed today under the Mortgage Banker's Association "Uniform Single Attestation Program".

Material instances of non-compliance during the reporting period, even if such non-compliance was subsequently corrected during the reporting period, must be disclosed on Form 10-K.

Conclusion

PwC views the implementation of Regulation AB as a positive initiative for the U.S. structured finance markets in general. However, some issuers may be challenged initially as they attempt to grasp the breadth of the regulation's requirements and the exact interpretation of certain sections.

With the deadline for compliance rapidly approaching, key considerations include ensuring enterprise-wide compliance with the regulation, development of contingency plans for possible non-compliance, monitoring the process and expense of implementation, and managing significant system/data changes which may be necessary to comply with the new reporting requirements. These issues, if not addressed properly, could cause timing delays in new issuances and restatement of non-compliant servicer reports, and while the SEC's potential reaction to such issues is difficult to predict, it could lead to a sponsor's loss of shelf registration eligibility if a sponsor of an ABS transaction fails to comply with Exchange Act reporting requirements. The compliance requirements extend beyond the issuing entities established by the depositor, and affects any issuing entity established directly or indirectly by any affiliate of the depositor with respect to the same asset class.

For more information on Regulation AB, please contact Tom Knox at (202) 414-1387 or tom.knox@us.pwc.com.

Internal Audit losing focus in the Sarbanes-Oxley world

By Christina Patilis

A recent PricewaterhouseCoopers survey of more than 270 internal audit organizations indicated that nearly 60% of reporting companies dedicate 50% or more of their internal audit resources to support Sarbanes-Oxley compliance.

The landscape of corporate America has been changed forever by the Sarbanes-Oxley Act. Compliance with Sarbanes-Oxley requires companies to ensure that internal controls over financial reporting are adequate and well-documented. This has left many companies experiencing a severe drain on their time, money and manpower. The Sarbanes-Oxley Act particularly affected the Internal Audit function, given the function's significant involvement in assisting management with documenting and testing controls. Internal Audit has added tremendous value to management in the Sarbanes-Oxley compliance process. However, many internal audit functions have become overextended and their involvement in Sarbanes-Oxley may have potentially undermined the function's ability to focus on its entire set of responsibilities.

A recent PricewaterhouseCoopers survey of more than 270 internal audit organizations indicated that nearly 60 percent of reporting companies dedicate 50 percent or more of their internal audit resources to support Sarbanes-Oxley compliance.[1]

In the past couple of years, the mission of many internal audit functions may have become too narrow in focus since the crux of the Sarbanes-Oxley Act relates to financial reporting risks – not *all* organizational risk. Accordingly, at many organizations, Internal Audit may have been led to focus on only one piece of the overall enterprise risk management puzzle, resulting in audit coverage of non-financial risks being put on hold.

This article suggests the three high level steps that Internal Audit can take to reinstate its mission of focusing on all organizational risk.

The Three-step approach

1. Compare internal audit activities against enterprise risk assessment results to identify gaps.

An Internal Audit's enterprise risk assessment process focuses on summarizing the company's business objectives, risk and controls and provides a method for allocating Internal Audit's resources toward the highest risks. With the emergence of the Sarbanes-Oxley Act and mounting pressure on management and the Audit Committee, Internal Audit's focus has been skewed toward financial areas. Accordingly, non-financial controls are often not being adequately covered, stakeholder expectations may not be met and ultimately the company's operational effectiveness and viability may be compromised.

[1] PricewaterhouseCoopers Internal Audit Survey, November 2004

Internal Audit should re-evaluate its enterprise risk assessment to ensure it incorporates the full gamut of organizational risk, including but not limited to strategic, operational, market, credit, technology, regulatory, reputational and financial risk. Operational risks due to management's shifting of significant resources, time and money to meet Sarbanes-Oxley requirements should also be considered. With resources being overextended, there is an increased likelihood of operational errors and organizational objectives not being achieved.

Internal Audit should compare the internal audit activities performed in the past year and scheduled for the upcoming year against the re-evaluated enterprise risk assessment. High risk non-financial areas that have not been addressed should be identified and timely coverage should be planned.

2. Identify resource shortfalls and develop realistic action plans.

Using the results from step 1 and based on first-year experiences with the Sarbanes-Oxley process, Internal Audit should identify upcoming resource shortfalls – both quantitatively and qualitatively. Even prior to the Sarbanes-Oxley era, Internal Audit typically has encountered challenges in developing and retaining solid auditing capabilities, industry knowledge, information technology skill sets, and other related expertise. With Sarbanes-Oxley, Internal Audit requires even more resources and those that are specifically attuned to financial reporting disclosures.

Internal Audit should consider:

- Having two separate and dedicated teams, one covering Sarbanes-Oxley, the other covering the remainder of the high risk audit areas. The benefit of this approach ensures that enough resources and the right ones are allocated to meeting internal audit's priorities. This approach often works more effectively in larger organizations with more complex processes.

- Supplementing its resources by participating in strategic co-sourcing arrangements with external firms. This can provide access to highly specialized skill sets as well as enable Internal Audit to focus on its higher risk priorities.

- Investing in technology applications developed for the Sarbanes-Oxley process that can improve the efficiency of the documentation and testing process.

- Having an independent quality assurance review performed of its function to identify resource constraints and opportunities for improving work process efficiencies. An independent view will also serve to provide management with a basis for increasing the level of resources.

3. Communicate and clarify expectations with management and the Audit Committee

Internal Audit's charter should be revisited and updated to reflect its role in Sarbanes-Oxley. Internal Audit should clearly communicate on a timely basis to senior management and the Audit Committee any gaps in coverage, particularly relating to high risk non-financial areas. Active and productive discussions should take place between Internal Audit and the Audit Committee regarding the expectations of Internal Audit and the resources to be allocated accordingly. Internal Audit should not hesitate to ensure that it receives the necessary increase in resources.

Conclusion

The corporate world has certainly changed after the Sarbanes-Oxley Act was passed into legislation. Never before has there been such an emphasis on evaluating and documenting risk and related controls. Internal Audit has received an excellent opportunity to demonstrate its fullest potential.

With this opportunity, Internal Audit also experienced its most significant resource challenges in history. Regardless of these challenges, Internal Audit must continue to focus on its true mission, which is identifying organizational risk across all dimensions and allocating internal audit priorities effectively.

For more information on Internal Audit Losing Focus in the Sarbanes-Oxley World, please contact Christina Patilis at (646) 471-2013 or christina.patilis@us.pwc.com.

Technical accounting

The decline in bank M&A activity: the beginning of the end or a temporary lull?

By Phil Weaver

Excess capacity in the US banking industry is a remnant of the arcane regulatory environment governing financial institutions and, as regulations have been largely standardized and streamlined, the industry has slowly and steadily consolidated.

Historically, banking M&A activity has been notable for its perennial consistency. From 1990 through 2003, there was an average of 348 bank M&A transactions announced annually. However, as the Boston Red Sox demonstrated last fall, some things are not as predictable as they seem. A slow bank M&A market in 2004 (it ranked 9th out of the last 14 years with 262 deals) was followed by an anemic first half of 2005 (98 announced transactions). Is the recent slowing in deal activity a short-term aberration or a harbinger of fundamental change?

There have been numerous catalysts driving bank acquisition activity over the last twenty years. More permissive banking regulations, banks weakened by the oil and gas and commercial real estate crashes in the 1980s and 1990s, the demise of the savings and loan industry, and new bank capital requirements have all been drivers that fueled historic activity. Yet, the underlying theme in the US banking market throughout the past twenty years has been simple excess capacity.

In 1985, there were over 14,000 banks in the US. Over the last two decades, the number of US banks has fallen 41% to 8,300. For comparative purposes, the UK has approximately 650 banks, or 60%, less than the U.S. on a per capita basis. In fact, every G-7 member country operates with a fraction of the number of banks that we have in the US. This excess capacity in the US banking industry is a remnant of the arcane regulatory environment governing financial institutions and, as regulations have been largely standardized and streamlined, the industry has slowly and steadily consolidated. This excess capacity—and the implicit inefficiencies it creates—will continue to be the prevailing force that drives US banking consolidation throughout this decade and into the next.

So, what has caused the recent decrease in bank M&A activity? We believe there are several factors:

Impact of Sarbanes-Oxley (SOX): SOX has had a powerful effect on the way banks do business, on their consideration of acquisition targets, and on acquisition timing. Most banks have worked diligently to comply with SOX internally and, being aware of the challenges they faced, have had little appetite to acquire, potentially, another company's internal control weaknesses. Over time, the effect of SOX on acquisition activity should diminish as the industry begins to develop a consistent approach to SOX compliance and as acquirers understand the market reaction to control environment weaknesses. Further, as banks become less internally focused on evaluating and documenting their own internal

control environment, they'll have more time to focus on acquisitions and integrations.

Low interest rate environment: The low interest rate environment of 2002-2004 has had a significantly positive effect on bank earnings resulting from wide interest rate spreads and heavy mortgage origination activity. As bank profits have been strong, the motivation to sell has correspondingly diminished. However, with the recent interest rate increases triggered by the Federal Reserve, many banks may find the new rate environment much more challenging. As some banks struggle with repositioning their balance sheet and generating earnings in a higher rate environment, selling the bank may become an attractive alternative, resulting in increased M&A activity.

Acquirer end-game: Another factor affecting deal volume is the decline in activity by historically active acquirers. Bank of America, JPMorgan Chase, and Wachovia (and their predecessors, Nationsbank, Bank One and First Union, respectively) were all active acquirers over the last twenty years. Yet, as each of these banks have reached national scale, their appetite for smaller bank deals has diminished. Several regional banks have, from time-to-time, appeared poised to fill this "acquirer vacuum", but, to date, none have shown the perennial appetite demonstrated by the top acquirers over the last twenty years. However, we believe that as interest rates increase and earnings become harder to generate, many of these regional players will look to acquisition activity more aggressively as a means to spur growth.

In summary, it's hard to be convinced that the recent slowdown in acquisition activity is anything beyond a short-term aberration resulting from a relatively unique confluence of environmental factors. The underlying economic issues that have driven bank acquisitions over the last two decades are still quite prevalent and, we believe, will result in continued consolidation in the industry for the foreseeable future. The challenge for bank management, as always, is how to effectively manage this continued consolidation for the maximum benefit of their shareholders.

For more information on bank M&A activity, please contact Phil Weaver at (646) 471-2170 or phil.weaver@us.pwc.com.

Technical accounting

FAS 133 – Is it time to take another look?

By Jay Harris
& Paul Griggs

It has been a tumultuous four and a half years since FASB Statement No. 133's (the "Statement" or "FAS 133") effective date on January 1, 2001 for calendar year companies. Whether it is new interpretations, implementation guidance or published restatements, this Statement has had its share of press. Given this myriad of authoritative literature and journalism, it is possible to lose focus of the Statement's fundamentals. Specifically, without strict documentation of hedging relationships, including tests of effectiveness and measurements of ineffectiveness, all derivatives should be recorded on the balance sheet at fair value with changes in value recorded in earnings. Is it time to take another look at FAS 133 to ensure that we are evolving with the Statement's pace and direction?

FAS 133 established the accounting and financial reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives on the balance sheet and measure those instruments at fair value. There have been numerous complaints over the complexity of the Statement. However, these complaints generally surround hedge accounting under FAS 133, which is optional. That said, in order to achieve hedge accounting, entities must perform tests to prove that hedging relationships are highly effective and measure ineffectiveness to properly report current period earnings. These tests and measurements are rarely simple and are often highly quantitative. In addition, entities must document hedging relationships contemporaneously following the Statements prescriptive guidelines.

The election of hedge accounting is further complicated by the volumes of published guidance across the hierarchy of Generally Accepted Accounting Principles. Published guidance includes the original pronouncement and three amendments, FASB interpretations, AICPA Industry Audit and Accounting Guides, AICPA Statements of Position, consensus positions of the EITF, and more than 180 Derivatives Implementation Group (DIG) issues, not to mention SEC rules, interpretations and speeches. This places a great responsibility on entities when electing hedge accounting and requires searching and sifting through the literature to ensure all potential questions and issues are addressed. This considered, it would be foolhardy not to leverage accounting policy departments, risk management, quantitative finance teams, external advisors and external auditors. Regardless, it is important to understand that even when taking a position which is believed to be supported within the literature, interpretation risk remains.

With recognition paid to the Statement's complexity, it is of foremost importance that the fundamentals be correct. Paragraphs 20-21 and 28-29 of the Statement provide the fundamental criteria required to qualify for hedge accounting. Failure to comply with these criteria has necessitated numerous accounting restatements and continues to be a key risk for all companies electing hedge accounting. "One of the fundamental requirements of FAS 133 is that formal documentation be prepared at inception of a hedging relationship…That formal documentation must identify…the entity's risk management objectives and strategies for undertaking the hedge, the nature of the hedged risk, the derivative hedging instrument, the hedged item or forecasted transaction, the method the entity will use to retrospectively and prospectively assess the hedging instrument's effectiveness and the

method the entity will use to measure the hedge ineffectiveness."[1] So where have entities erred? The vast majority of announced restatements have risen from "sloppy documentation and aggressive interpretations of Statement 133's hedge accounting guidance"[2], as well as instances of "shortcutting or minimizing the process."[1]

The industry response must be quite simple. Precision with accounting for hedging relationships and thorough documentation are essential to achieve hedge accounting. Without this diligent documentation, hedge accounting should be abandoned with changes in value of derivatives reported through earnings. Hedging relationships must be contemporaneously designated and sufficiently documented. "The method used for assessing hedge effectiveness and measuring ineffectiveness must be documented with sufficient specificity so that a third party could perform the measurement based on the documentation and arrive at the same result…[Entities] should focus on the clarity of…disclosures when they use hedges…including reasons for their use, associated hedge strategies and methods and assumptions used to estimate fair value…"[1]

Perhaps the most compelling evidence to reinforce this need for continued rigor and robust documentation surrounding an entity's application of hedge accounting are sound bites from recently published articles and press releases announcing accounting restatements, a few examples of which follow. Although company names have not been included, these sound bites involve some of the largest, most well respected companies in the financial services industry.

- The Company will restate due to hedge rules. Transactions do not technically comply with rules for accounting for derivatives and hedges.
- This mistake is one judged through an ever-changing lens. The Company has tripped up on a very technical test.
- The Company will restate past financials. The accounting for certain derivatives was incorrect and needs to be adjusted.
- The Institution did not qualify for hedge accounting because of deficiencies in the application of FAS 133. The Company's methodology of assessing, measuring, and documenting hedge ineffectiveness was inadequate and was not supported.
- Accounting decisions may not have been the best decisions given what the Company now knows. The Company assumed certain hedges were perfectly effective, improperly ignoring the ineffectiveness in hedge relationships. The Company failed to perform assessment tests; documentation was ambiguous or was not contemporaneous.
- The Entity will restate to properly account for certain derivative transactions and to make corrections for recording errors.

So as we look back four and a half years to FAS 133's inception, we recognize what a long journey it has been. But now is the time that we should take a second look, with renewed focus and rigor around accounting for hedging relationships and robust documentation requirements.

For more information on FAS 133, please contact Jay Harris at (704) 344-7885 or jay.w.harris@us.pwc.com; or Paul Griggs at (704) 344-7524 or paul.griggs@us.pwc.com.

[1] U.S. Securities and Exchange Commission (2005, March 4). Issues associated with SFAS 133, Accounting for Derivatives and Hedging Activities. Current Accounting and Disclosure Issues in the Division of Corporation Finance, II.K.1-3.

[2] James, John M. (2003, December 11). Speech by SEC staff: 2003 thirty-first AICPA national conference on current SEC developments. Retrieved from http://www.sec.gov/news/speech/spch121103jmj.htm

Technical accounting

Reporting IFRS: considerations for domestic and foreign banks

By Aaron Snodgrass and Norbert Porlein

The widespread adoption of International Financial Reporting Standards ("IFRS") is shaping the financial reporting framework of the financial services industry. Domestic and foreign banks in the U.S. are considering the impact of adopting IFRS as they either are required to complete financial statements under IFRS, or consider the high level impact of IFRS on their net income or net capital.

Specifically, there is focused attention on IFRS by (1) foreign banks with U.S. branches, agencies and subsidiaries, and (2) U.S. banks with overseas subsidiaries with regulatory reporting requirements mandating IFRS financial statements or respective reporting to head office and/or regulators. Banks in either of these categories should be making significant progress in their transition to IFRS.

Many U.S. domestic banks are now also seeking to understand the impact of IFRS on their financial statements for the following reasons:

- Potential requirement to reconcile U.S. GAAP with IFRS—The Committee of European Securities Regulators ("CESR") issued a Consultative Paper in April 2005 recommending inclusion of a reconciliation to IFRS for U.S. GAAP financial statements filed in the European Union. This will require a U.S. GAAP to IFRS reconciliation for all financial statements filed in relation to securities offering and registered in the E.U.

- Convergence of U.S. GAAP and IFRS—standards are shaping future accounting standards. Accounting for stock based compensation, financial instruments, and the current combined IASB and FASB business combinations and revenue recognition projects are prime examples.

- Benchmarking against competitors—international banks and analysts continue to seek comparable financial statement data to benchmark foreign competitors.

- Mergers and acquisitions—identifying the U.S. GAAP and IFRS differences is essential for a U.S. bank acquiring an IFRS reporter, or vice versa, an IFRS reporter acquiring a U.S. GAAP entity.

- Development of industry practice—as banks adopt IFRS, industry best practice continues to evolve. Certain aspects of hedge accounting practices are prime examples of where foreign banks are looking to the U.S. and evolving best practices.

- Subsidiary reporting to foreign regulators—many regulators require financial statements prepared under local GAAP. With convergence and its growing acceptance this is often IFRS. Furthermore, the adoption of the Basel II regulatory capital requirements will largely be based on IFRS.

- Analysis of counterparty credit risk—assessing credit risk of an IFRS reporter's financial statements will require an in-depth analysis of the application of IFRS and the related U.S. GAAP differences.

U.S. GAAP and IFRS differences that banks and other financial institutions need to consider

The most significant challenge in converting from U.S. GAAP to IFRS is determining the relevant GAAP differences. The impact of these differences depends on the bank and its application of U.S. GAAP. Significant accounting differences between IFRS and U.S. GAAP often reside in the details, causing recognition, measurement, or presentation differences. Some of these differences are noted in table 1 below:

Table 1: Significant U.S. GAAP and IFRS differences noted for banks.

Derecognition of financial assets	Different derecognition criteria exists between U.S. GAAP and IFRS which could render different accounting results. Derecognized financial assets will need to be reviewed under IFRS. Specifically under: IFRS – financial assets are derecognized based on the transfer of risks and rewards first; transfer of control is a secondary consideration. U.S. GAAP – Derecognition is based on control. U.S. GAAP requires legal isolation of assets even in bankruptcy.
Consolidation and Special purpose entities	Consolidation rules for SPEs can render significantly different results. IFRS – Consolidation is required when the substance of the relationship indicates control. Under IFRS the concept of a "qualifying SPE" does not exist and there is no exemption from consolidation for QSPEs. U.S. GAAP – The "primary beneficiary" consolidates an SPE if requirements for "variable interest entities" are met. To avoid consolidation, the SPE must be a qualifying SPE.
Classification of financial instruments	The classification of financial instruments can impact the balance sheet measurement, income statement recognition and financial statement presentation of the financial instrument. IFRS –The "financial asset or financial liability at fair value through profit or loss" category provides the ability to fair value certain financial assets, such as loans, as well as financial liabilities, reducing the need for complex hedge accounting. This option is subject to amendment under an exposure draft, which limits the application of this classification. Additionally the E.U. does not allow the use of this option for financial liabilities. U.S. GAAP – Under the 'mixed attributes model' financial assets are measured at market/fair value or amortized cost depending on their classification. Financial liabilities are mandatorily measured at amortized cost. Asset-Liability management is dependent on complex hedge accounting provisions to reflect accounting results that correspond to the company's economic activity.
Hedge accounting	While on the face hedge accounting models under IFRS and U.S. GAAP are similar, there are substantial differences affecting primarily banks. Some specific provisions under IFRS differing from U.S. GAAP are: • Shortcut method to assess interest rate hedge effectiveness is not permitted • Hedging mortgage service rights is not permitted. • Partial designation of a hedging instrument is permitted. A hedging relationship may not be designated for only a portion of the time period during which a hedging instrument remains outstanding. • Using non-derivatives (loans, bonds, receivables and payables) to hedge foreign exchange risk is permitted. • Portfolio hedging is permitted in limited circumstances.
Loan loss reserves	The IASB does not believe there are differences in the principles which underlie IAS 39 and US GAAP in respect of provisioning for loans or groups of loans because both GAAPs require that provisions be established only for incurred losses. Accordingly, provided that a methodology applied under US GAAP adheres to the principle of incurred loss, the IASB would expect such a method to be consistent with IAS 39. However, provisioning under US GAAP has to be analyzed to determine whether the documented methodology is consistent with principles outlined in IAS 39. Under U.S. GAAP, interest on non-accrual loans is often recognized on a cash basis. Under IFRS, interest is accrued using the discount rate from the impairment calculation.

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Revenue recognition and amortization	Differences exist between U.S. GAAP and IFRS in the amortization of discounts/premiums and the related calculation of effective interest rates and subsequent recognition of revenue. • Loan origination costs – internal costs must be incremental to be deferred, whereas U.S. GAAP allows directly attributable costs to be deferred. • Prepayments – under U.S. GAAP, if prepayments are difficult to estimate, a new effective rate is calculated and the premium / discount is adjusted. Under IFRS, the premium/discount is adjusted based on the revised discounted cash flows using the original effective rate. • Amortization of premiums/discounts for variable rate loans is up to the reset date, where as under U.S. GAAP amortization is over the life of the loan.
Insurance contracts	IFRS contains a comprehensive definition of an insurance contract and requires specific risk-based disclosures. A bank with significant insurance operations will need to carefully evaluate whether its insurance contracts fall within this definition. Under IFRS, contracts not meeting the insurance contract definition are treated as financial instruments. Additionally, shadow accounting is permitted under IFRS, but is required under U.S. GAAP. Shadow accounting matches the measurement of financial liabilities, and the associated income statement recognition, to associated financial assets. A different accounting treatment under IFRS also exists for separate accounts and reinsurance contracts.
Regulatory reporting	• U.S. – In April 2005, the U.S. Securities and Exchange Commission (SEC) provided a one-time accommodation for foreign private issuers adopting IFRS prior to, or for the first financial year commencing on or after, January 1, 2007. It permits for their first year of reporting under IFRS to file two years rather than three years of statements of income, changes in shareholders' equity and cash flows prepared in accordance with IFRS, with appropriate related disclosure. The accommodation retains current requirements regarding the reconciliation of financial statement items to U.S. GAAP. • E.U. – CESR recently recommended disclosure remedies covering significant IFRS differences in financial statements filed in the European Union by registrants reporting under U.S., Canadian and Japanese GAAP.
Generic IFRS considerations	In addition to the above, banks will need to carefully consider other IFRS standards, including first time adoption rules in IFRS 1. These include, but are not limited to, accounting for foreign currency, pension plans, share based payments, restructuring provisions, intangible assets, and others.

Considerations in converting to IFRS—market observations

The challenges U.S. banks face when transitioning to IFRS are significantly different to the issues encountered in regions, such as Europe and Asia. Virtually all banks in the U.S. reporting IFRS are required to do so for group reporting purposes, and therefore, the focus tends to be on recognition and measurement, rather than presentation. A U.S. bank therefore needs to focus on

- Identifying U.S. GAAP and IFRS GAAP differences early in the conversion process
- Defining accounting policies and first time adoption choices to minimize U.S. GAAP and IFRS GAAP differences
- Defining group reporting responsibilities and ensuring issue resolution processes are in place
- Ensuring adequate resources with knowledge of both IFRS and U.S. GAAP are available
- Providing adequate training and ensuring knowledge transfer mechanisms are established in all areas of the business, not only in the financial reporting functions.
- Partnering with an IFRS advisor, with a global network, to provide both the parent/head office and subsidiary bank support in the implementation of IFRS across the group
- Communicating the impact of IFRS with the markets, analysts and shareholders.

Banking specific conversion tools

The experience of PwC's IFRS conversion specialists is complemented by the following tools that are available to assist banks and financial institutions in transitioning to IFRS.

Comperio™—Comperio™ is a fee-based advanced research and reference system which provides comprehensive access to global financial reporting and technical literature.

Applying*IFRS*™— Applying*IFRS*™ is a practical solution set of banking specific issues resolved by PwC's global network of IFRS specialists. It is available through Comperio™ and www.pwc.com/ifrs.

P_2P—From Principal to Practice—P_2P is PwC's proprietary self study learning solution enabling inexpensive training in core IFRS standards by a large number of people.

Banking model financial statements—our banking specific model IFRS financial statements, together with our First Time Adoption financial disclosures provide disclosure guidance for IFRS reporters.

Disclosure and measurement checklists—our disclosure and measurement checklists will assist in identifying general IFRS differences.

Similarities & Differences: A comparison of IFRS and US GAAP—provides a broad understanding of the key similarities and differences between IFRS and US GAAP. It considers all pronouncements issued under IFRS and US GAAP up to June 2004.

Websites—Many of the tools described above are available on PwC's websites, www.pwc.com/ifrs and www.cfodirect.com. These sites provide regular information on IFRS updates and developments.

Final remarks

U.S. banks need to pay attention to IFRS for many reasons. The most important is to foresee changes in accounting standards by looking at IFRS accounting developments and understanding the impacts of change to the bank's business.

Particular challenges exist for global banks with local IFRS reporting obligations and banks with parent company reporting under IFRS in converting from U.S. GAAP to IFRS. These require an in-depth understanding of the specific application of U.S. GAAP and the differences with IFRS. A thoroughly planned and adequately staffed conversion project, using experienced advisors and suitable conversion tools, are essential.

For more information on the conversion to and application of International Financial Reporting Standards for banks and other financial institutions, please contact Aaron Snodgrass at (646) 471 3715 or aaron.snodgrass@us.pwc.com; or Norbert Porlein at (646) 471 5956 or norbert.porlein@us.pwc.com.

Technical accounting

Automated valuation models—how to manage your model risk

By Ken Martin
& Steve Robertson

Over the last four years, the residential real estate market has experienced an unprecedented increase in the volume of real estate financing transactions. Growth has been driven by low interest rates and rising property values, which has led to unprecedented numbers of new home purchases (both primary housing and investment properties), refinancings of debt on existing homes, and new home equity loan and line transactions. In addition, during this time period, mortgage originators have sought to increase the speed and lower the costs associated with real estate financing transactions. Moreover, many institutions are using automated property valuation tools in risk management or internal control activities such as fraud detection and prevention, borrower default and prepayment modeling, and loss mitigation. The combination of these phenomena has resulted in an increased use of Automated Valuation Models ("AVMs") for determining or confirming the value of property securing real estate financing transactions.

AVMs are proprietary valuation models developed and licensed by vendors, or developed by mortgage secondary market participants. AVMs employ property-level information from databases and sophisticated modeling techniques to estimate the fair market value of real estate collateral.

On May 16, 2005, the federal banking agencies[1] released interagency guidance applicable to all financial institutions engaged in home equity lending (both home equity lines of credit and closed-end home equity loans). The guidance outlines expectations for sound risk management practices for home equity lending programs. One particular element of the guidance[2] addresses collateral valuation management practices. Specifically, the guidance states that, for institutions to use AVMs to support property appraisals in a safe and sound manner, institutions must validate the AVMs periodically to "mitigate the potential valuation uncertainty" in the model, and to ensure that institutions utilize the most reliable and accurate AVM for underwriting and risk management purposes. Specifically, the guidance states that the AVM validation process must include "back-testing a representative sample of valuations against market data on actual sales."[3]

The following describes one approach to back-testing AVMs, which institutions can consider as part of their AVM risk management process.

An approach to AVM validations

Validating an AVM typically requires selecting a sample of properties from recent originations to be submitted to one or more AVM vendors in order to evaluate the accuracy of the AVM and the reliability of the vendor. After receiving the AVM estimates from a vendor, an institution must analyze the AVM's performance using a range of performance metrics, statistical analyses and tests. The results of these analyses must be formally documented and analyzed, with conclusions, and the basis for

[1] Collectively the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Association

[2] The guidance covers a variety of risk management elements including product development, marketing/ sales activities, third party originations, collateral evaluation management, account management, portfolio management, operations/ servicing/ collections, secondary market activities, credit risk classifications, loan loss reserves and capital.

[3] Also, the guidance refers institutions to the model validation guidance outlined in the Office of the Comptroller of the Currency's ("OCC") Bulletin OCC B-2000-16, "Risk Modeling – Model Validation" That was issued May 30, 2000 (Please see the article "Managing Model Risk" in the Spring 2003 Banking Issues Update for a discussion of OCC Bulletin 2000-16.)

the conclusions must be fully supported and documented as well.

AVM property sample

According to the interagency guidance, the AVM sample must include properties that are "representative of the geographic area and property type" for which an AVM is used by the institution. The size of the sample will likely depend on a number of factors, but will be driven primarily by the size of the institution's lending footprint, the diversity of the institution's loan portfolio, and the number of properties a vendor will permit an institution to submit to it for evaluation purposes. This is an important consideration as an institution must be able to periodically submit a sample of properties to a vendor that is large enough to be representative of the institution's geographic area and property types, among other factors. Institutions should consider this validation requirement when negotiating a licensing agreement with an AVM vendor. Ideally, the property sample should be based on recent transactions in which the sales price or appraised value has not been publicly recorded, and therefore the property value has not reached the public databases used by AVM vendors.

AVM performance analysis

Analyzing the performance of an AVM is challenging because it can be evaluated across a number of different factors. Typically however, institutions evaluate AVM performance in two main areas:

- Coverage—The percentage of properties for which an AVM returns estimates for a given set of properties. All other things being equal, more coverage is better than less coverage.

- Accuracy—The precision of the AVM estimate relative to a benchmark value, such as a property sales price or appraised value. All other things being equal, a more accurate AVM is better than a less accurate AVM.

AVM coverage varies by AVM vendor. Some vendors offer AVMs that provide national coverage, while others offer regional coverage. AVM accuracy is typically measured at the property level using an error rate (i.e., AVM estimate minus Sales Price divided by Sales Price). Error rates for a group of properties in the sample can be summarized by key statistical measures: mean error rates, median error rates, or the distribution of error rates. Statistical tests, such as analysis of variance and t-tests, can be performed on the error rates in order to assess whether the differences in the error rates exist for geography (e.g., state level or county level), property type (e.g., single family detached or condominium), and property value ranges.

After completing the AVM performance analysis, the institution must document the assumptions, conclusions, and recommendations for review and approval by management.

Role of risk management and credit policy in the process

An institution's Risk Management and Credit Policy groups are critical parties that must be involved in the oversight of the AVM validation process. From a model governance and risk policy perspective, Risk Management typically has a role in defining an institution's approach (broadly) to model validation, including defining roles and responsibilities that ensure independent, objective reviews, developing policies and procedures, and establishing documentation requirements. Any AVM validation program would typically be executed in conformance with corporate standards.

As it relates specifically to the design of an AVM validation program, Credit Policy and/or Risk Management typically have a role in defining criteria for what constitutes "acceptable" uses of an AVM, acceptable performance of an AVM (i.e., accuracy, reliability), and policies covering the initial due diligence and approval of AVM vendors based on their ability to provide AVMs that meet the defined performance criteria, and their willingness to permit ongoing validation of their services. Risk Management's/Credit Policy's involvement should be continuous, to ensure the initial design and ongoing performance of the program are reasonable and well controlled.

Conclusion

While AVMs can offer financial institutions faster loan origination cycle times, lower delivery and fulfillment costs, and automation of key risk management processes, improper use of AVM technology can expose an institution to increased credit losses and regulatory risk. In this article, we have discussed a methodology for validating AVMs that we believe is one method of performing analysis in a manner consistent with recently released regulatory guidance. Whatever the approach taken, a formal AVM validation program is necessary to meet regulatory expectations and will help an institution better measure and manage its AVM and vendor risks.

For more information on AVM validation programs and processes, please contact Ken Martin at (202) 822-4491 or kenneth.w.martin@us.pwc.com; or Steve Robertson at (612) 596-4438 or steve.robertson@us.pwc.com.

Technical accounting

FASB clears two DIG issues with widespread effect on embedded derivatives

By Thomas Barbieri, Muneera Carr and Rachel Ferguson

The Financial Accounting Standards Board (FASB) recently issued Derivatives Implementation Group (DIG) Issue B38, *Evaluation of Net Settlement with Respect to the Settlement of a Debt Instrument through Exercise of an Embedded Put Option or Call Option ("B38")*, and DIG Issue B39, *Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor ("B39")*. These two DIG issues provide guidance in applying FAS 133, *Accounting for Derivative Instruments and Hedging Activities, as amended ("FAS 133")*. B38 will change the accounting for many embedded put options and call options in non-public debt instruments; B39 was introduced to minimize the impact of B38 for call options exercisable by debtors, for example, prepayment features. Together, these two issues provide sweeping changes to the current accounting for embedded derivatives in non-public debt instruments.

When evaluating whether embedded puts and calls meet the definition of a derivative, the key assessment is whether the call or put can be "net-settled."

The basic premise of FAS 133 is that all derivatives should be reported at fair value on the balance sheet, with changes in fair value recorded as income or expense ("marking to market"). When devising the model, the FASB was concerned that companies might move derivatives inside other arrangements to avoid marking them to market. As a result, the FASB included guidance to capture "embedded derivatives," that is, those that may be included in other contractual arrangements, which are called hosts. An example of an embedded feature is a prepayment feature within a loan. A prepayment feature is a call option, which gives the debtor the right, but not the obligation, to buy the loan at a fixed price—that is, prepay the loan—at a certain time or during a certain period, such as over the life of the loan, for example. Embedded derivatives must be accounted for separately from their hosts, that is, marked to market, if:

- their economic risks and characteristics are not clearly and closely related to the hosts;
- the hosts are not reported at fair value; and
- the embedded derivatives would meet the definition of a derivative if not embedded.

Call options and put options in debt instruments must be carefully considered under the FAS 133 embedded derivative model. When evaluating whether embedded puts and calls meet the definition of a derivative, the key assessment is whether the call or put can be "net-settled." An instrument is net-settled if neither party is required to deliver an asset, but settles the net payable or receivable. An instrument is also net-settled even if an asset is delivered, if that asset can be easily sold in the market or an offsetting contract can be purchased, or if the asset is readily convertible to cash.

For publicly traded debt instruments, accountants have agreed that the net settlement criteria can generally be met since, by definition, there is a public market for such instruments and therefore the instrument can be readily converted to cash. That said, it is not so easy to determine if a non-public instrument can be net-settled, but B38 provides guidance around the definition of net settlement, specifically concerning puts and calls in non-public debt instruments. Because many companies do not currently consider prepayment options within non-

public debt instruments to have the characteristic of net settlement, B38 has a widespread impact on several industries.

Non-public debt instruments are not easily sold in the market or readily converted to cash. Accordingly, to be net-settled in accordance with FAS 133, neither party must be required to deliver an asset. There has been some disagreement over whether an asset is delivered when a debt instrument is prepaid. Some historically believed that when a debtor prepays an obligation, the debtor receives the canceled note in return, which was an asset in the hands of the lender. Thus, gross physical delivery of an asset has occurred and the debt was not net-settled. Others believed, now including the FASB, that because the note is not an asset in the hands of the debtor, an asset has not been delivered and thus, the instrument is net-settled. The FASB incorporated this view in B38: if a put or call option embedded in a debt instrument is exercised, then the settlement of the obligation by the debtor to the creditor constitutes net settlement.

Since the implementation of FAS 133, many issuers and holders of non-public debt instruments have not marked embedded put and call options in debt instruments to market. This is because they held the first view, that settlement of an obligation constituted delivery of an asset, and since the instrument was not readily convertible to cash, the embedded put and call options were not considered net-settled. Under B38, the embedded put and call options in debt instruments will be considered net-settled. Thus, the embedded put and call options will meet the definition of a derivative and will have to be further considered under the remaining FAS 133 criteria to determine if they must be accounted for separately. B38 may not be applied by analogy to embedded put and call options in hybrid instruments that do not contain debt host contracts. B38 also cannot be applied in situations where put or call options are added to a debt instrument by a third party.

The remaining FAS 133 criteria to consider are whether the host is reported at fair value and whether the embedded feature is clearly and closely related to the host. Determining whether the host is reported at fair value is a fairly easy assessment, but determining whether an embedded feature is clearly and closely related to its host is often not so easy. Paragraph 13 of FAS 133 provides guidance regarding whether an embedded derivative with an interest rate or interest rate index as an underlying is clearly and closely related to its host. B39 somewhat mitigates the impact of B38 by providing an exemption from the requirements of paragraph 13(b) of FAS 133 for call options that are exercisable by the debtor. In other words, if a call option is exercisable by the debtor, such as a prepayment feature in a loan, then it is automatically considered clearly and closely related to its host. In that case, it would not be accounted for separately. It is worth noting that mortgage-backed securities do not contain call options and are therefore not subject to B39.

Both B38 and B39 will be effective at the same time, the first day of the first fiscal quarter beginning after December 15th. Once these issues are effective, companies will apply them prospectively to new and existing contracts – they will not change the previous accounting in prior reporting periods. Implementation of B38 will require a cumulative-effect-type adjustment in accordance with the transition provisions in paragraph 51 of FAS 133 for all existing embedded put and call options that will need to be accounted for separately because they meet the definition of a derivative. Under B39, if a previously marked-to-market call option no longer qualifies as a derivative, the fair value will be added back to the carrying value of the instrument.

Because of the guidance in B38 and B39, the FASB is also cleared technical revisions to B16, which provides additional guidance on how to determine if embedded put and call options are clearly and closely related to their hosts.

For more information on DIG B38 or B39, please contact: Tom Barbieri at (973) 236-7227 or thomas.barbieri@us.pwc.com; or Rachel Ferguson at (973) 236-4541 or rachel.a.ferguson@us.pwc.com.

Regulatory

The anti-money laundering information supply chain: reducing the cost of compliance

By Tom Messina and Deven Swim

The cost of non-compliance with Anti-Money Laundering (AML) regulations is clear. Recent experience has shown that non-compliance can result in civil and criminal penalties imposed by AML laws as well as other consequences that include public embarrassment, loss of profitable business, liquidity problems caused by deposit withdrawals, increased legal and accounting fees incurred due to regulatory investigations, increased cost and loss of business as a consequence of lower debt ratings, and declines in stock prices. What is not as clear, however, is why the cost of compliance has remained so high.

Diagnosing the Issue

In the past, Know Your Customer (KYC) and AML activity monitoring data was not a priority for many financial institutions. Instead, the data used for monitoring these tasks was a by-product of ordinary business processes such as account opening, transaction processing, and tax reporting. These processes rarely shared common goals, priorities, or owners.

Since the passage by Congress in 2001 of the Patriot Act and several high-profile AML regulatory situations, the level of regulatory scrutiny of AML programs has steadily increased. Various financial institutions concluded that their existing AML programs were inadequate and sought to find new or more sophisticated automated programs to ensure compliance. These systems were often seen as the "silver bullet" to the AML compliance problem, yet many of these systems, as deployed, have fallen and continue to fall short of management and regulatory expectations. This has led to the high cost of AML compliance. Symptoms include:

- Large numbers of false positives relating to potential suspicious activity creating extensive backlogs in the review process
- Continued regulatory comments on AML systems
- Ineffective AML risk rating of customer base
- Multiple versions of the "truth", especially as it relates to customer information
- Spreadsheet proliferation
- Missed or inaccurate Currency Transaction Report (CTR) filings
- Undetected anomalies in transaction level data

So if AML system automation alone is not the answer, then what is? The answer exists within the Information Supply Chain (ISC). The ISC not only improves regulatory compliance but also improves the business as a whole.

What is the information supply chain

Similar to the physical supply chain (and fundamentally an integral part of it) is a set of the key data production activities (in effect, discrete corporate processes) that continuously produce and consume data as it moves through one or more information supply chain links on its way to becoming actionable business insight. These critical business processes include business operations, internal management reporting, compliance, and regulation among others.

At every step, the organization's key data consumers are either pulling data from or adding data to these information supply chains. These data stakeholders or constituencies will vary from company to company and from process to process. However, these groups typically include business executives, industry analysts and Information Technology (IT) administrators, compliance analysts, internal management accountants, and auditors.

At the heart of each ISC process is the Data Life Cycle (DLC). The DLC refers to the discrete data processes in each link of the ISC chain where data is created, sustained, analyzed, reported, and retired. The way to an efficient and effective ISC can be achieved by examining, diagnosing and repairing the data processes in each of the ISC links. As the saying goes, "a chain is only as good as its weakest link". The same principle applies to the ISC.

Anti-money laundering and the ISC

There are specific requirements for AML that can be applied to each link within the DLC. The key to reducing AML compliance costs is to focus on each of the links within the DLC. Financial institutions need to ensure that there are no deficiencies within the links. A financial institution can decrease the cost of AML

Figure 1: the information supply chain

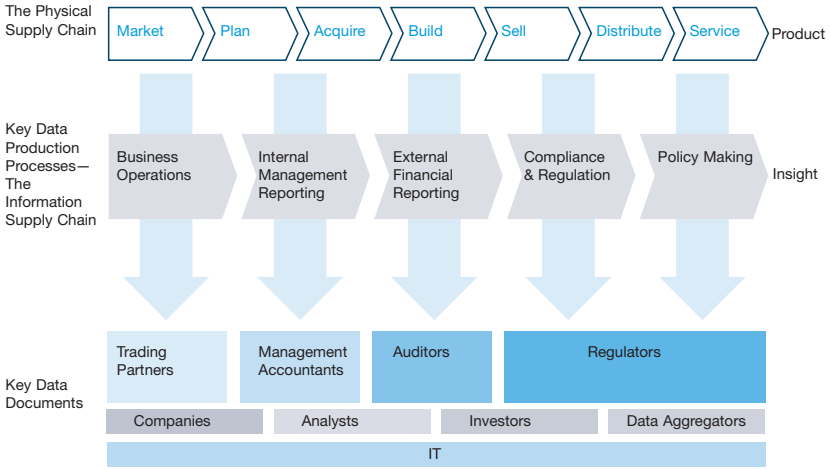


Figure 2: the data life cycle

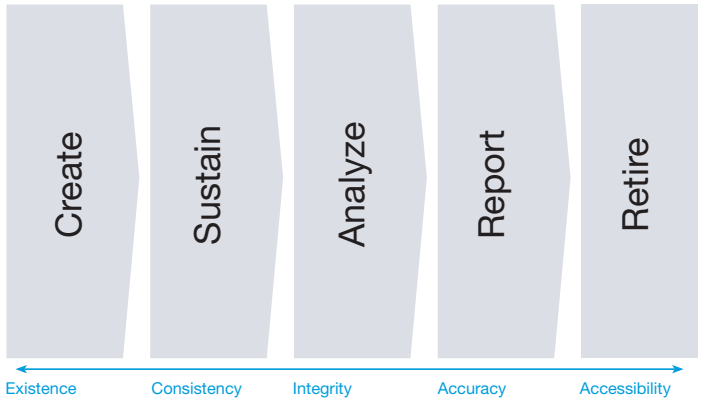
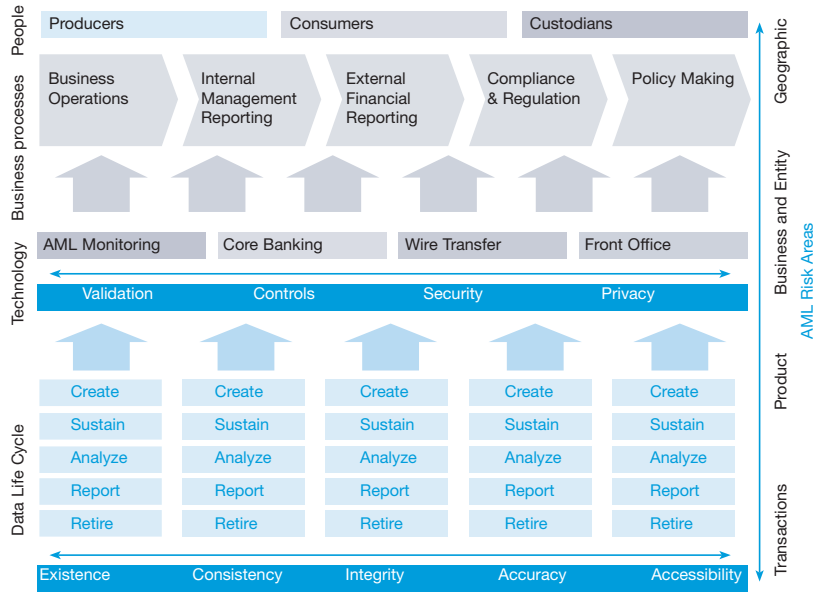


Figure 3: the relation between the information supply chain and the data life cycle



Regulatory

compliance and the risk of not complying with regulatory requirements by committing to strengthening the links in the DLC. An in-depth examination of each of the links in the DLC follows.

DLC links

Create

Creation is the point of entry into the DLC. Financial institutions collect data about their customers, transactions, and processes every day. There are many reasons why data that is created and collected must be complete and accurate in order to have a successful AML program, including regulatory requirements, and internal and external reporting requirements.

Institutions should evaluate the data that is needed for a successful AML program and compare it to the data that is currently being collected. This exercise validates the existence of required data and identifies any gaps in current data collections. Institutions must also apply the necessary levels of controls and validation to the data at the time of creation, thus ensuring the integrity and consistency of the data. For example, when developing an AML risk model that successfully assigns a money laundering risk score to customers, it is necessary to identify all of the data points that are needed to support the risk model. These data points need to be collected or created in a controlled manner at the time of new account opening. If they are not properly collected at that point, the downstream risk scores assigned to the customer will be inaccurate and subject to regulatory scrutiny.

Transaction monitoring is another area within an AML program where creating accurate data is crucial. Various financial institutions do not have the appropriate processes and controls in place to consistently identify true currency transactions. This issue leads to inaccurate AML alerts and structuring reports which increase time required to address false positive results.

Creating a complete data collection that meets or exceeds data quality requirements is the first step in a sound AML monitoring program.

Sustain

Sustaining the integrity of AML data as it flows through systems is a prerequisite to fulfilling compliance obligations. After data is created, it is essential that the data quality remains intact. Data can be used for several different business purposes, such as operations, marketing, and finance. Data is often sent to various systems within an organization, and it has a tendency to be augmented and changed to meet different departmental needs. These data changes can potentially affect the accuracy and completeness of the data which can have a direct impact on downstream uses of this data. Monitoring systems that can be implemented include reconciliation engines and data quality monitoring engines. These systems can continuously compare the data to regulatory and business requirements to ensure that data, critical to a successful AML program, stays accurate and consistent.

Analyze

Analysis is a vital link in the data lifecycle for AML. An in depth examination of data is crucial for AML systems to be effective. Most financial institutions have implemented an AML monitoring system that investigates customer transactions to detect possible suspicious activity. These systems analyze customer transaction behaviors, transaction patterns, and transactions that exceed pre-established thresholds. However, these AML monitoring systems are only as effective as the quality of the system's source data, the configuration of the system, and the experience of the analyst reviewing the results. In addition, to further evolve the improvement of the analysis performed, new ways of mining the data, such as predictive analytics, are necessary. For example, by using predictive analytics an institution may discover a certain region that poses a higher risk of money laundering. This new information can be applied to an AML Risk Model, and customers that fall within this region can be monitored more closely. Furthermore, predictive analytics can be applied to customer transactions to further optimize AML monitoring systems. Transaction patterns associated with money laundering can be used by predictive analytic engines to predict the types of money laundering transaction patterns that may occur in the future. This information can be applied to the AML monitoring applications to optimize the results which will save institutions time and money, and reduce regulatory risk.

Report

Reporting is a vital part of the AML DLC for financial institutions because it is here where processes converge and the transformation of raw data into useful information occurs. Both speed and information integrity is vital to making reporting effective. Financial institutions can apply business and industry experience to the information, assisting them in compliance with fluid regulatory requirements and gaining insight into future regulatory requirements. This insight can be used to create innovative processes and systems that will keep them ahead of the regulatory curve. The long-term success of an AML program ultimately comes from the knowledge gained by the information contained on AML and compliance reports. This knowledge is dependent on each stage of the entire data lifecycle. The integrity of the AML DLC is only as strong as its weakest link. If there are deficiencies anywhere along the AML DLC reports can be inaccurate and untimely and can

put a financial institution at risk of regulatory non-compliance.

Financial institutions open themselves up to immediate regulatory risk when reports such as CTRs or Suspicious Activity Reports (SAR) are incorrectly filed or not filed at all. These reports are only as accurate as the underlying data, so it is crucial that the financial institution is confident in the strength of their AML ISC.

Retire

The last stage of a comprehensive AML DLC is the archiving and retention policies of the data and information that has been created throughout the ISC. Retiring data is often overlooked, but there are important decisions that need to be made about what data needs to be retained and the duration of the retention. AML reports such as CTRs, SARs, and the AML monitoring system customer profile reports should be retained for historical reporting purposes. A strategy needs to be developed and adopted for AML related transaction information in order to satisfy potential regulatory requirements, such as FINCEN 314a and 314b requests or subpoenas.

Benefits to repairing the ISC

A financial institution can leverage the benefits of being proactive and maintaining an effective AML ISC. A direct result is the benefit of good governance in the compliance function. But beyond that, there are cost savings within the compliance function as well as the business value added throughout the enterprise as a whole. Some of these benefits include:

- A framework that allows for enhanced all-purpose use of customer data in a cost-efficient manner
- Process improvement gains by consolidating the duplicate account opening processes that normally exist within banks
- Gains in efficiency and effectiveness of the compliance function due to the increased effectiveness of the AML monitoring system
- Increased confidence that AML systems adhere to specified AML program policies and procedures
- Knowledge garnered from data mining that not only reduces the number of false positives generated by the AML monitoring system but also allows for a deeper understanding of the customer by reporting their behavioral patterns.

AML automated monitoring systems alone may not be the answer to effective AML programs as automation addresses only one area of the ISC and then only two of the dimensions of the underlying data lifecycle, i.e. analyzing and reporting. To reduce the ever increasing cost of compliance, AML automated systems must be implemented in conjunction with an enterprise data management strategy based on a comprehensive view across the AML ISC that addresses each aspect of the DLC.

For more information on "The Anti-Money Laundering Information Supply Chain: Reducing the Cost of Compliance", please contact Thomas Messina at (646) 471-4757 or thomas.messina@us.pwc.com; or Deven Swim at (617) 530-7875 or deven.swim@us.pwc.com

Regulatory

Regulatory capital developments—U.S. application and implementation of the Basel 2 framework: what's ahead?

By Daniel L. Weiss

Since the early 1990s, US bank supervisory guidance and regulatory authorities have recognized that the U.S. banking system, and the global financial services sector, have sustained substantial transformation due to market and technological developments. While there are a large number of insured banking institutions, significant consolidation and concentration has occurred. For example, as of the first quarter 2005, there were approximately 8,930 U.S. based banks and savings associations with $10.3 trillion in banking assets of which the top 50 banks accounted for approximately 60%.[1] A relatively small number of very large "systemically significant" institutions, with national scope and international activities have emerged, exhibiting operational and organizational complexity and diversification into new activities and financial services and products, particularly in capital markets. The banking agencies and Congress recognized these market developments in legislation and regulation.

In particular, the banking agencies, established a risk-focused examination approach and stepped up inter-agency and sector coordination. In considering the application of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," issued by the Basel Committee on Banking Supervision in June 2004 and generally known as the Basel 2 Framework ("Framework"), the US federal banking agencies have jointly issued guidance and agreed on key principles.[2] One of these is that the U.S. will have a bifurcated regulatory capital regime after implementation of the Framework.

U.S. Implementation of the revised Framework is expected only to apply to approximately 20 of the country's largest internationally active banking organizations. These institutions will be required to qualify, employ and disclose measurement and risk management methods and output for the Advanced Internal Ratings-based approach to credit risk ("A-IRB") and the Advanced Measurement Approach to operational risk ("AMA"), in addition to current requirements. The institutions comprising the balance of the US banking system will remain subject to the existing U.S. capital adequacy regime, based on the first Basel Capital Accord, with some expected modifications for directional consistency with the U.S. adoption of the Framework. In addition, the leverage capital ratio will continue to apply to all banks and savings associations.

Framework implementation continues to build momentum among supervisors and the large, complex, internationally-active banking institutions that will be subject to the Framework. U.S. supervisors recently

[1] Source: FDIC Statistics on Depository Institutions Report http://www2.fdic.gov/sdi with data as of 3/31/05.

[2] Banking agencies include: the Board of Governors of the Federal Reserve System ("FRB"), the primary Federal supervisor of US bank holding companies, including those that are designated financial holding companies, and of state chartered commercial banks that are members of the Federal Reserve System, The Office of the Comptroller of the Currency ("OCC") supervisor of national banks, the Office of Thrift Supervision ("OTS") supervisor of Federally chartered thrifts and the Federal Deposit Insurance Corporation, primary supervisor of non-member state chartered banks.

[3] On May 16, 2005, Federal Reserve Board Governor Mark W. Olson indicated that, "Results from QIS4 were more widely dispersed and showed a larger overall drop in capital than the agencies had expected. This was the impetus for deciding to delay the notice of proposed rulemaking for Basel II. We now have to determine whether these results arose from actual differences in risk among respondents, differences in stages of preparation (including data limitations) among respondents, limits of the QIS4 exercise, or a possible need for adjustments to the Basel frame-work itself." - Annual Washington Briefing Conference of the Financial Women's Association, Washington, D.C.

noted that results of the fourth quantitative impact study completed in early 2005 indicate the need for further conceptual and data refinements prior to issuing a proposed rule, now anticipated later in the year.[3] The agencies are soliciting feedback from various stakeholders in the US banking system, indicating a willingness to address stakeholder concerns, which may well lead to substantive revisions of the Framework and current draft guidance through the rule-making process. Broadly, the current focus includes:

(a) clarification, calibration, and adoption of the Framework through:

- proposed revisions to the existing risk-based capital adequacy regulations
- additional supervisory guidance
- consideration of possible changes to risk-based capital regulations for US institutions not subject to the Framework; and

(b) the process for qualification of the A-IRB and AMA.

Timing is generally perceived as tight for initial implementation; particularly with respect to ensuring data sufficiency as well as development, approval, and integration of the necessary risk and reporting infrastructure, such as systems, processes and methodologies, for qualification of the advanced measurement approaches. Notwithstanding some uncertainties with the proposed rules, institutions' comprehensive implementation plans and processes are tending to shift from an emphasis on understanding requirements, defining needs and identifying gaps to addressing gaps and design and integration of the needed infrastructure in "business as usual" operations. The shift prompts more and diverse resources being marshalled within the subject institutions to qualify and fulfill the implementation plans. The banking regulators, too, are integrating specialists into institution-specific dedicated examination teams to ensure responsive tracking and feedback.

This article seeks to provide some perspective on certain topical issues and the state of the US implementation of the Framework applicable to banks as of the Spring 2005. Some of the issues highlighted are being addressed through supervisory coordination while others await clarification of the standards and experience with the Framework once it is "in production". Contemporaneous developments, such as with respect to US and international financial accounting for securitizations and derivatives, reporting taxonomy, and significant efforts that institutions are dedicating to meeting the Sarbanes-Oxley disclosure controls requirements, are also influencing the Framework implementation process and the dialogue around certain of these issues.

Data sufficiency

Data sufficiency is an essential and recurrent implementation focus. Dependencies include clarification of Framework definitions that range from categorization of products/activities to refinement of attributes, measurement parameters and materiality thresholds. From an A-IRB approach, US institutions have introduced granular multi-dimensional credit rating schemes and are accumulating portfolio and transaction histories and loss experience and preparing for sufficient information to back test key factors, such as probabilities of default, exposure at default and loss given default. AMA efforts also progress, particularly in the identification and collection of risk and loss events, and will likely accelerate with further guidance and industry and supervisory consensus on the details of the measurement approaches – and possible mechanisms for sharing loss data for quantitative analysis.

Much effort has been devoted to defining data attributes and mapping for both advanced approaches, prompting increasing dialogue with supervisors on definitions and calibration. For example:

- scoping of equities and retail accounts, such as the definition and treatment of defaulted and unseasoned accounts
- treatment of credit hedges, and:
- access to detail on risk assets managed by others.

Institutions are reviewing their existing systems and management processes that are variously managed on a legal entity, business line, geographic, and/or product basis to ensure appropriate alignment, granularity and accessibility. The mapping efforts include attention to access and accuracy of reference information that facilitate appropriate grouping and categorization of exposures. The data mapping and gap analysis associated with Framework implementation has been contemporaneous with and has generally benefited from compliance with Section 404 Sarbanes-Oxley, particularly with respect to the formalization of systems, processes and controls documentation and facilitating monitoring of operational risk loss events.

"Home/host" oversight

Home/host oversight, local/foreign office implementation and national treatment represent a mix of policy and practical concerns for US and peer supervisors and subject institutions. A number of concerns are being addressed through multiple tracks including among international supervisors via the Accord Implementation Group ("AIG") and through bilateral and supervisory group dialogue, as well as among individual institutions and their home and host regulators. These key concerns include:

- consolidated banking supervision objectives and coordination/harmonization of differences in measurement and reporting requirements for subsidiaries
- the definition of significant subsidiaries
- the treatment of branches and "non-significant" subsidiaries, and:
- the allocation of diversification benefits to subsidiaries.

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In addition to the timing of pending determinations, the home/host dialogue is expected to consider the impact of varied applications that will intensify data requirements, add reconciliations (including across measures and legal/reporting entity versus line of business basis) and increase reporting production resources.

Trading book versus banking book

Trading book versus banking book boundary distinctions can be significant, particularly with respect to structured products, repurchase transactions, and off-balance sheet activities. Active dialogue among supervisors, implementing institutions and interested constituencies around accounting definitions, cross-industry practices and form versus substance considerations will help define what is subject to A-IRB and the market risk measures. Tangential to these considerations is the measurement of counterparty credit risk, which so far US supervisors and subject institutions have identified as an opportunity for refinement, but may be subject to prioritization and the evolution of the Framework.

Disclosure requirements

These are being addressed by supervisors, implementing institutions and other key constituents. Defining information that satisfies the disclosure principles of the Third Pillar, public filing disclosure requirements and auditing standards represent a key dynamic, particularly in the post Sarbanes-Oxley environment. Considerations include what constitutes proprietary information, the level of detail regarding governance, methodological design, parameters, inputs and derived factors, nature and effectiveness of key controls associated with the derivation, and presentation of the measures and process.

Competitiveness

Competitiveness in the context of Framework implementation can be dimensioned as: inter-jurisdictional, inter-industry and domestic intra-industry. National treatment differences in calibration and scoping of particular products and disclosures are being tracked and addressed by international supervisors via the AIG and related home/host dialogue; inter-industry (investment banking and insurance).

The most significant US development regarding inter-industry/market convergence is the adoption in 2004 of an alternative net capital requirements for broker-dealers that are part of consolidated supervised entities subject to oversight by the Securities and Exchange Commission. These requirements include comprehensive oversight, risk measurement and reporting regime for large internationally active US-based investment companies that have been designed to follow the Framework principles.

Finally, as noted above, the Agencies expect to revise current risk-based capital rules for non-Framework banks coincident with the effective adoption of the Framework. The revisions would directionally harmonize the two measurement systems, which could result in reductions or increases in certain risk-based capital charges associated with certain exposures and activities, such as mortgages and other collateralized obligations, investment securities, and securitizations.

Qualification of approaches

U.S. banking agencies indicate that the proposed rule implementing the Framework will require a formal "notification" process that anticipates an 18-month horizon, which would allow for a one-year parallel run. Institutions that intend to apply the IRB and AMA methodologies at the earliest possible date (i.e., beginning in 2008) will have had to have fully implemented the necessary systems, with all remedial actions identified by supervisory staff, for use throughout 2007. The Agencies:

- anticipate proposing that (a) no specific approval will be required to initiate parallel runs; and the (b) parallel runs would be confidential and reported on a quarterly basis to the primary Federal regulator; and,
- expect that "systems underlying the advanced approaches would be operating on a stable basis, with inputs derived from reliable and well-established data sets".

Affirmative qualification during the parallel run period would be necessary in order to use the IRB and AMA results for regulatory risk-based capital purposes on a going-forward basis. The Agencies recognize that, "the Framework-based capital rule is still in development and that the initial qualification process for individual institutions may take more than a year." Institutions expect to maintain the existing (Basel I) risk-based capital measurement process for several years after completion of the parallel runs, for example until at least 2009, under the earliest timeframe.

Conclusion

Supervisors, subject institutions and interested constituencies expect that as Framework implementation progresses there will be continued enhancement of risk measurement, management, monitoring, reporting and oversight activities. Once implemented, the Framework will help refine the capital estimation and allocation processes that facilitate prudential supervision of an increasingly integrated global banking system.

For more information on Basel 2, please contact Daniel Weiss at (202-414-4305) or dan.weiss@us.pwc.com

Refinement of BHC regulatory capital components—Trust Preferred and other hybrid capital

Effective April 11, 2005, the Federal Reserve Board ("FRB") adopted a final rule amending its risk-based capital standards for bank holding companies ("BHC"), which continues Tier 1 (core) capital treatment for qualifying trust preferred securities (TPS), subject to stricter quantitative limits. To facilitate application of these limits, certain Tier 1 capital components have been defined as "restricted core capital elements" which include: cumulative perpetual preferred stock, trust preferred securities, and minority interests in the equity accounts of certain consolidated subsidiaries, including REIT preferred. The rule also clarifies and codifies qualifying criteria and supervisory guidance regarding TPS and other restricted core capital elements. Among the key aspects addressed are the following.

Qualifying restricted core capital elements, in aggregate, are limited to:

- 15% of Tier 1 capital elements, less goodwill (adjusted for any associated tax liability) for internationally active BHCs, and
  - defined as BHCs with consolidated assets greater than $250 billion or on-balance-sheet foreign exposure greater than $10 billion based respectively on the most recent year-end FR-Y9C and Country Exposure Report (FFIEC 009),
  - Qualifying mandatory convertible preferred securities are excluded from the 15% sublimit, and together with other restricted core capital elements may count up to 25% of Tier 1
- 25% of Tier 1 capital elements, less goodwill, for all other BHCs.
- Excess amounts generally may be included in Tier 2 capital, of which some elements would be further limited with subordinated debt and limited-life preferred stock to 50% of Tier 1 capital. Institutions will be able to order Tier 2 capital elements (i.e., counting non-limited elements first) to reduce crowding out that this limitation might otherwise impose.
- A five-year transition period applies ending March 31, 2009, during which these limits are generally treated as targets with required supervisory consultation and plan to reduce reliance for institutions with amounts in excess of the respective limits.

Grandfathered Tier 1 treatment will apply to certain TPS issued prior to April 15, 2005, of which proceeds were invested in subordinated debt that may not satisfy certain required characteristics.

Qualifying TPS will move from Tier 1 to Tier 2 capital status during the remaining five years to maturity associated with the underlying debt obligation, during which a cumulative straight-line exclusion would apply, consistent with the treatment of limited life instruments.

The requirement for trust preferred securities to include a call option has been eliminated

Standards for the junior subordinated debt underlying trust preferred securities eligible for tier 1 capital treatment have been clarified (e.g., deferral notice, seniority, acceleration, voting rights)

Regulatory financial reporting is reaffirmed to generally conform with GAAP, and that regulatory capital composition and computations may necessarily differ from GAAP.

The rule stipulates that BHC issuance and significant redemptions before maturity of regulatory capital qualifying TPS, and similar instruments, would generally require prior consultation with the relevant Federal Reserve Bank; and reaffirms that the FRB can grant or disqualify favorable capital treatment of such instruments on a case by case basis. For the final text see: http://www.federalreserve.gov/boarddocs/press/bcreg/2005/20050301/attachment.pdf.

For more information on BHC, please contact Daniel Weiss at (202-414-4305) or dan.weiss@us.pwc.com

Regulatory

Avoiding BSA/AML enforcement actions

by Edward Monahan

Last year, regulators imposed collectively more than 20 formal enforcement actions as well as a multitude of informal agreements on banks relating to BSA/AML deficiencies.

In 2004 and 2005, the evolution of Bank Secrecy Act/Anti-Money Laundering ("BSA/AML") risk management standards was accelerated by an unprecedented number of high profile Bank Secrecy Act/Anti-Money Laundering ("BSA/AML") regulatory enforcement actions. Last year, regulators imposed collectively more than 20 formal enforcement actions as well as a multitude of informal agreements on banks relating to BSA/AML deficiencies. These actions emphasized regulators' views that internal controls for preventing money laundering and terrorist finance are a cornerstone of corporate governance as well as an indicator of enterprise-wide risk management integrity. The scope and intensity of regulatory consent orders and associated monetary fines were unprecedented.

Two prominent cases illustrate the perils of BSA/AML non-compliance: 1) AmSouth paid $54 million in fines stemming from agreements with the Federal Reserve and FinCEN as well as a deferred prosecution agreement with the U.S. Department of Justice;[1] and, 2) Riggs National Bank paid $51.7 million for BSA violations incurred at its international private banking and Embassy Banking business divisions.[2] At the same time, both banks have sustained huge costs for corrective programs and remedial management: AmSouth plans to spend $9 million annually to fix BSA/AML problems[3] while Riggs National Bank absorbed $73 million in overall costs to fix deficient processes and close troubled operations.[4] BSA/AML enforcement-related sanctions obligated Riggs National Bank to shut down key business lines and replace senior management. Thereafter, in May of 2005, the Riggs National Board sold Riggs Bank to Pittsburg National Corporation. In an overall sense, BSA/AML risk management has become the costliest area of compliance for U.S. banks: industry forecasts suggest that institutions will have spent more than $11 billion on AML program development, consulting assistance, software and training from 2002 to 2005.[5]

The financial services industry has observed these developments with a mixture of fear and loathing. A public enforcement action causes reputational damage, and remedial management costs cripple an institution's strategic expansion and operating effectiveness. Until recently, BSA/AML regulatory enforcement has generally lagged behind evolving technologies, global financial infrastructures and instantaneous communications. However, recent federal and state enforcement scope has hardened: the severity of BSA/AML enforcement actions by the four federal regulators[6] is without precedent, as is the criminalization of violations that had been historically treated as civil regulatory matters.

Regulatory expectations for banks center around the requirement that BSA/AML compliance be based upon a written, Board-approved BSA/AML program[7] comprised of four elements:

1) Internal Controls supporting compliance with BSA regulations;

[1] AmSouth Bancorporation, S.E.C. Form 10-Q, Management's Discussion and Analysis of Financial Condition and Results of Operations as of 9/30/04– Third Quarter and First Nine Months Overview, page 20.

[2] Riggs National Corporation, S.E.C. Form 10-K, Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations as of 12/31/04 – Item 7A: Quantitative and Qualitative Disclosures About Marlet Risk, page 30. Fines were: a) $25.0 million from the OCC and the Financial Crimes Enforcement Network in the second quarter of 2004; b) $16 million from the United States Department of Justice recorded in the fourth quarter of 2004; c) $8 million accrual for fourth quarter of 2004 related to litigation in Spain; and, d) $2.7 million for settlement of stockholder litigation.

[3] AmSouth Bancorporation, S.E.C. Form 10-Q, under section entitled Third Quarter Settlements, page 20.

[4] Riggs National Corporation, S.E.C. Form 10-K, as above, at page 30.

2) Independent testing performed by internal auditors or staff;

3) Designated Compliance Officer responsible for day-to-day oversight; and,

4) Training of staff involved with areas relevant to BSA/AML compliance.

This program must allow banks to:

- Know their customers;
- Report large cash transactions;
- Identify suspicious activities;
- Maintain systems and processes equal to the risks of relationships, products and activities; and,
- Forestall terrorist finance and money laundering through cooperation with law enforcement and regulators.

Comprehensive regulatory expectations have been spelled out clearly by the Federal Reserve and the OCC. The Federal Reserve has declared that "financial institutions are expected to have a sound anti-money laundering compliance program…(that)…must include well-defined processes to identify suspicious activities, and those processes should be tailored to the risk and complexity of each business line."[8] Further, the OCC has offered an extraordinary and blunt declaration of principle regarding the rise in enforcement actions and penalties. It serves as a warning to bank managements and compliance officers: "Unlike other examination areas, a statutory mandate exists that instructs the OCC to issue a cease-and-desist order (C&D) whenever a bank fails to establish and maintain a BSA compliance program…."[9]. The OCC's Chief Counsel has added "…what was good enough in the past may not be good enough now…"[10]

Based upon a careful reading of recent Written Agreements, Memoranda of Understanding and Cease & Desist Orders,[11] banks should prepare for expanded scope BSA/AML examinations by focusing on the following key internal control issues:

1) Management oversight: Examiners will assess a bank management's commitment to BSA/AML compliance by evaluating whether internal controls are supported by sound procedures, independent audit testing, competent compliance staffing and effective employee training. Such regulatory actions also emphasize that the business unit, rather than the compliance department, must assume responsibility for maintaining compliance and monitoring customer behavior.

2) Suspicious activities: Examiners want to be assured that a bank can distinguish between customary activities and unusual transactions, and that a process exists to investigate, analyze and articulate reasonable SAR filing decisions based upon credible information. Examiners will probe information technology systems and back-end analytical departments in hopes of finding a sound case management process that is supported by reasonable financial intelligence. Indeed, while certain businesses and activities may demand more intensive customer due diligence because of their inherent BSA/AML risk (e.g., private banking versus retail consumer deposit-taking), bankers will be punished severely for complacency or inaction. BSA/AML control standards are rising across all areas of financial institution activity. Excessive defensive filings may indicate that a bank does not know how to distinguish between questionable activities and legitimate customer behavior.

3) Customer risk rating: Examiners will consider a bank to be a "high-risk institution" if it is inattentive to a need for automated systems, internal controls and testing. Sophisticated recordkeeping and monitoring systems are very expensive to acquire, implement and maintain. Therefore, financial institutions should plan and budget aggressively for major upgrades over the next few years as BSA/AML risk management software continues to evolve. These resources support comprehensive ranking of risks aligned with customers, products and activities. Banks that deploy sound internal controls while operating in high-risk jurisdictions and offering high-risk products will meet regulatory standards; those operating

[5] Article entitled "Banks Taken to Cleaners in Terrorist Search" by Tomas Kellner, Forbes, May 14, 2004.

[6] Office of the Comptroller of the Currency (OCC), Federal Reserve Bank, Office of Thrift Supervision and Federal Deposit Insurance Corporation.

[7] Patriot Act Section 352 and 12 CFR 21.21(c).

[8] Remarks by Federal Reserve Bank Governor Bies to the Institute of International Bankers, March 14, 2005.

[9] OCC Bulletin 2004-50: Enforcement Guidance for BSA/AML Program Deficiencies, November 10, 2004.

[10] Remarks of OCC Acting Chief Counsel Stipano to Florida International Bankers Association, February 10. 2005.

[11] Publicly released enforcement documents such as: Riggs National Bank, AmSouth, Banco Popular, ABN Amro, Standard Chartered, Banco de Chile, HSBC, Western Union, Eagle National Bank of Miami and Hudson United Bank.

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in lower-risk areas with standard products and services will fail examinations if they view controls as an unnecessary cost rather than a critical necessity.

4) Policies & procedures: Examiners believe that Patriot Act requirements for Customer Identification Programs (that support Know-Your-Customer capabilities) should be implemented and operative, because such CIP regulations and rules were finalized long ago. Examiners will inspect a bank's BSA/AML Program for completeness and effectiveness. They expect to find evidence that accurate and prompt regulatory reporting, suspicious activity and OFAC monitoring, compliance oversight, due diligence review capabilities and employee training are operative and effective.

Lack of a sound BSA/AML Program or failure to execute remedial measures for correcting unfavorable examination findings will provoke issuance of an enforcement order that typically carries aggressive timelines for fixing deficiencies. Weak BSA/AML Programs may need to be strengthened within 60 days. Reporting failures may lead to a requirement to reexamine historical transaction data over a previous one- to three-year period. This is a complex, costly and burdensome undertaking that requires banks to gather and upload historical data into a separate server in order to filter transactions against enhanced suspicious activity detection criteria. These tasks must often be accomplished within 180 days. During this "look-back" project period, with a bank under an enforcement order, strategic initiatives and growth plans may be prohibited by regulators.

Banks ought to adopt a proactive, anticipatory approach to regulatory risk management by preparing for outside scrutiny and identifying deficiencies before regulatory examinations uncover major problems. Management or Internal Audit should perform detailed analyses of customer files, monitoring programs, staffing levels, BSA/AML procedures, controls and information systems in order to provide senior management with cost estimates and timeframes for pre-exam remedial actions. Given the nature of money laundering and terrorist finance, the most important BSA/AML regulatory expectation relates to action-oriented management: do not wait for examiners to find problems. Bank management should identify customers, contain risks and implement solutions before they are "ordered" to do so.

For more information on Avoiding BSA/AML Enforcement Actions, please contact Edward Monahan at 617.530.6398 or edward.monahan@us.pwc.com.

Previous successful regulatory examinations offer no assurance that new or current BSA/AML scrutiny will be lenient. Indeed, complacency may lead to sanctions and fines. Prudent bank management should aggressively inspect the sufficiency of BSA/AML programs in order to assess these issues:

- Has the bank evaluated its BSA/AML risks? Is the program tailored to specific identified risks? If the risk assessment was completed by an internal department or an external consultant, have I analyzed and agreed to its conclusions? Does the analysis target all relevant specific business risks?
- Do the conclusions of the last examination report relate to embedded BSA/AML issues that have not been addressed? Current outstanding issues or problems often turn into next year's regulatory enforcement action.
- Do officers and staff understand the severity of BSA/AML risks and the consequences of inaction to the financial institution both today and tomorrow?
- Is the bank's BSA/AML audit testing program and, indeed, the internal auditors themselves, sufficiently strong to identify and act promptly on problems that may have been missed or problem customers that the bank may have failed to identify?

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