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WHAT YOU NEED TO KNOW
FINANCIAL SERVICES REGULATIONS

Investor & Consumer Protection Regulations in Financial Services

A look at evolving regulations around investor and consumer protection, and the business and technology implications for global financial services institutions

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Contents

1 Highlights

The recent financial crisis exposed a number of key weaknesses in the global regulatory system, which set the stage for significant losses for investors and consumers. Investors and consumers bore the brunt of a number of practices such as misselling, aggressive practices, and non-disclosure of conflicts of interest, which led to their loss of trust in the functioning of the financial markets. With the aim of restoring confidence in the financial system and enhancing protection for investors and consumers, regulators aim to reform current practice.

Though regulators around the world have reached consensus on the key areas of regulatory design that need to be reformed, the near-term focus varies from region to region. In the U.S., the core focus has been on reforming the retail banking model around mortgages and credit cards. In Europe, the focus is on reforming the distribution of banking, insurance, and investment products. The four key areas of regulatory reform we see emerging are: enhancing transparency of product structure, mitigating conflict of interests in distribution, prevention of aggressive practices, and prevention of moral hazard in rating agencies.

The implementation of regulatory reforms has started moving forward as new and existing regulatory agencies create rules for financial services institutions and start implementing them in the financial markets. Existing business models of financial services institutions are expected to be affected by the emerging regulations, which would significantly increase their burden of compliance. Financial services institutions are expected to respond by increasing the standardization of products to minimize the risk of non-compliance. Professional services firms can assist financial services institutions in overcoming the challenges posed by the evolving regulations. Financial services institutions need a robust reporting system supported by a high-integrity data management system to comply with the increasing reporting requirements placed on them by regulators. A greater degree of automation in compliance processes is essential.

In order to ensure compliance with enhanced fiduciary standards, financial services institutions need an analytics-driven, multi-channel customer relationship management system to enforce the regulations across all channels.

2 Introduction

The financial crisis exposed weaknesses in the global financial system. Chief among them was the web of interconnections across global financial institutions and investments, which resulted in a cascading effect that gained strength and toxicity. Key weaknesses revealed by the financial crisis include:

- Lack of transparency
- Noncompliance of accounting practices
- Inadequate risk measurement and management process
- Misaligned compensation and incentive policies
- Lack of sufficient governance and supervision

Throughout 2008 and 2009, regulators around the world acted quickly to take measures to increase the strength of the overall financial system. Though these regulatory reforms are still evolving, regulators have attempted to fill the gaps that emerged during the crisis (especially regarding risk assessment and measurement), strengthen the capital base, adopt global standards for minimum liquidity, and enhance accounting standards to reduce systemic risks.

As regulations are expected to evolve to create a risk-aware financial system, the momentum for change is converging around six key regulatory themes.

Exhibit 1: Key Themes Driving Regulatory Reforms and Structural Changes across Global Financial Services Institutions

Capital

Low levels of capital held by institutions, coupled with high levels of leverage served to multiply risk, were identified as some of the root causes of the financial crisis

Global Cross-Border Regulation

Large, cross border institutions pose special risks hence will be subject to increased scrutiny

Regulatory arbitrage due to non-uniform regulations is a risk to global financial systems stability

Liquidity Management

Financial-crisis highlighted inadequate liquidity buffers and poor liquidity risk management within banks, resulting in a liquidity crisis

Key Regulatory Themes

Accounting Standards and Financial Regulations

Accounting standards prior to the financial crisis did not reflect the true financial position of financial services institutions hence there is a continued push for a harmonized set of accounting standards

Investor and Consumer Protection

Investors have suffered significant losses during financial crisis that was stimulated in large part due to flawed practices and structural weaknesses of the financial institutions

Remuneration, Governance and Supervision

The focus and link to risk should be improved, and supervisory structures are seen evolving to better detect both idiosyncratic and systemic risks

Source: Capgemini analysis, 2011

This paper reviews and summarizes the regulatory reforms emerging around Investor and Consumer Protection.

3 Current and Evolving Regulatory Reforms in Investor and Consumer Protection

“It’s only when the tide goes out that you learn who’s been swimming naked.”

Warren Buffet

Consumers and investors have suffered significant losses during the financial crisis, driven in large part by flawed practices and structural weaknesses of financial services institutions such as:

- Misaligned compensation and short-term incentives encouraging risk
- Lack of unbiased advice for investors
- Absence of thorough due-diligence for in-house and third party products
- Aggressive charging models and fee structures

3.1. The Need for Investor and Consumer Protection in Financial Services

In the wake of the financial crisis the consumer protection debate has focused heavily on financial services, with a host of different and overlapping measures being discussed at both global and regional levels.

While past scandals involving Enron and Worldcom had led to a strong regulatory response around financial statements and their accuracy, the regulatory environment for financial firms remained highly passive. Regulators took a predominantly hands-off approach when managing the larger financial institutions. Moreover, non-banking financial firms such as hedge funds and insurers remained outside the purview of regulators as they catered primarily to the so-called “sophisticated” investors[1].

The financial crisis exposed the fact that weaknesses in the regulatory design set the stage for significant losses for investors and consumers. There are five key areas around investor and consumer protection identified by global regulators as needing reforms:

- **Lack of Adequate and Appropriate Information:** Use of fine print, technical language, and large consumer information documents to market their products has been long criticized, as it reduces the comparability of product and fails in educating consumers appropriately. These kinds of practices have led to misselling of products and moderation of competition among financial services institutions during the financial crisis.
- **Use of Aggressive Practices:** Financial institutions employed aggressive practices in the marketing and design of product features to maximize their revenue potential. Fraudulent financial intermediaries leveraged these products to target economically vulnerable segments. Good examples are the practices of the U.S. mortgage and credit card industry, which came under intense scrutiny post-crisis as regulators contemplated the possibility of placing constraints on fees, and changing models to prevent such practices and protect consumer interests in the future.
- **Non-disclosure of Conflict of Interest:** Investment banks structuring investment products suffered inherent conflicts of interests due to possible collaboration between each bank’s sales staff and product managers. Investors suffered losses due to non-disclosure of these conflicts at the time of sale.
- **Opaqueness of Asset Valuation Process:** The valuation of over-the-counter derivates and synthetic products such as synthetic collateralized debt obligations was left to the judgement of the issuer. The opaque nature of this valuation masked the potential size of losses in the early stages of the crisis, which resulted in panic as the crisis worsened due to inability of investors to effectively estimate the size of losses.
- **Predatory Lending Practices:** Retail lenders in general and mortgage lenders in particular came under intense scrutiny post-crisis for their poor lending practices. Mortgage originators had resorted to fraudulent practices such as misstatement in mortgage applications, and misselling to consumers which led to mortgage loans which consumers could not afford. In an environment of increasing interest rates consumers would not be able to refinance the mortgage at a lower interest rate. As interest rates started rising, such loans turned bad leading to consumer bankruptcy and large investor losses.

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[1] An individual with either annual income of US$ 200,000 or net worth of over US$ 1 million is considered as a sophisticated investor as defined by Securities Exchange Commission

Though the aim of the global regulators is to improve the investor and consumer interests, there is a debate whether all consumers will actually benefit.

Critics claim that due to tougher regulatory regime not everyone will be able to afford the financial services which they could earlier.

3.2. Regulatory Reforms to Protect Investor Interests

Consumer and investor protection has emerged as a key feature of the emerging framework for banking regulations globally. While in the U.S., the core focus has been on reforming the retail banking model around mortgages and credit cards, in Europe the distribution of banking, insurance, and investment products is expected to come under greater scrutiny as the EU business conduct regulations are rolled out in 2012.

There are four key areas where regulators are focusing their efforts in order to enhance the investor and consumer protections.

3.2.1. Enhancing Transparency of Product Structure

Lack of transparency across pricing, product structure, and exceptional charges hindered the decision-making capability of consumers as comparison between competing options was nearly impossible. Regulators believe that increased transparency will help investors make informed decisions and also increase market competition.

In the U.S., the Dodd-Frank Act has empowered the Consumer Finance Protection Bureau to develop standardized consumer information forms for financial products which enhance the consumer's ability to compare competing offers. On similar lines, Europe's Undertakings for Collective Investments in Transferable Securities IV demands the use of a standardized key investor information document while communicating with consumers. Such measures are aimed to increase the transparency of products and drive greater competition in the market, which would benefit investors and consumers in the long term.

3.2.2. Mitigating Conflict of Interests in Distribution

Commissions earned by investment advisors from product providers has traditionally contributed to a significant portion of an advisor's income. These dependencies compromise the independence of advice offered by "independent" investment advisors. Regulators are now seeking new distribution structures to eliminate misalignment between consumer and advisor interests. Barring commissions earned from selling the product is an idea that has gained significant purchase in Europe.

In the U.K., the Financial Services Authority is implementing Retail Distribution Review which prohibits acceptance of commission by independent investment advisors. In the same spirit, the European Commission's Markets in Financial Instruments Directive II has proposed a ban of provider inducements to bolster investor protection.

3.2.3. Preventing Aggressive Practices

Legislators and regulators in the U.S. have been most active in reigning in the aggressive practices of financial services institutions by putting in place explicit rules of conduct. The key focus areas of regulators have been the mortgage origination and credit card issuer practices followed by financial services institutions.

The CARD Act was passed by the U.S. Congress in 2009, which placed numerous restrictions on the charging models employed by credit and debit card issuers. A ban on overdraft fees on debit cards, and restrictions on the method of calculating interest on balances are some of the restrictions placed by the CARD Act. Laws applicable to bank and non-bank mortgage originators have been modified by the Dodd-Frank Act to include consumer protection such as a duty of care for mortgage originators, and a minimum standard for extensions of mortgage debt. These regulations aim to shield consumers by constraining the aggressive practices of financial institutions.

3.2.4. Preventing Moral Hazard in Rating Agencies

The global financial system has always relied on independent rating agencies. Rating agencies were highly criticized for driving demand for the troubled mortgage-backed securities, asset-backed securities, and collateralized debt obligations, which were rated as AAA assets by them.

Regulating the rating agencies is an area in flux as regulators evaluate multiple options to mitigate the inherent moral hazard. The Australian Securities and Investments Commission have taken the lead by ruling that rating agencies can be sued for ratings given to investment products. However, western regulators are taking a more measured approach where they require rating agencies to expose their models and assumptions in greater detail. For example, in the U.S., a 5% credit risk retention requirement for securitizers aims to promote a more risk aware behavior.

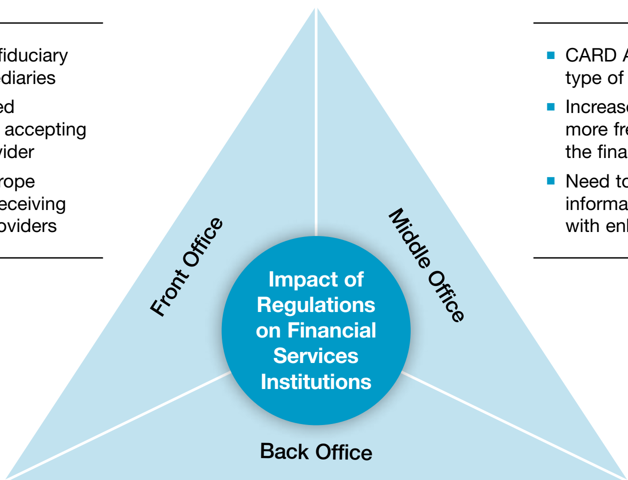
3.3. The Impact of Regulatory Reforms

The regulatory reforms in the U.S. and Europe have resulted in increased regulation of the products marketed to investors and consumers. Restrictions have been placed on the fee model of products, their distribution, and methods of information disclosure. For example, the European Commission's regulation of the retail mortgage lending market proposes a European Standardized Information Sheet, minimum standard of advice, and disclosure of conflicts of interest.

These regulations are expected to impact the entire value chain (see Exhibit 2) of financial institutions. Financial institutions will have to redesign existing processes and practices, such as information disclosure practices. They will also have to provide more proactive tracking of conflicts of interest, and assessment of consumer suitability for product to ensure compliance with the evolving regulations once regulators formalize the rules.

Exhibit 2: Impact of Regulatory Reform on Financial Services Institutions

- Dodd-Frank Act mandates uniform fiduciary standard for all the financial intermediaries
- UK Retail Distribution Review banned independent financial advisors from accepting any commissions from product provider
- MiFID II, an overhaul of MiFID in Europe proposes to abolish advisors from receiving any "inducements" from product providers



- CARD Act in the U.S. places constraints on type of products and charging models
- Increased reporting requirements demand more frequent and more detailed reports from the financial institutions
- Need to maintain accurate and up-to-date information regarding consumer to comply with enhanced fiduciary standards

- Standardization of consumer information forms will drive a need for an accurate data management system
- Financial institutions need to detect, track, and report conflicts of interest proactively

Source: Capgemini analysis, 2011

4 Business Implications for Financial Services Institutions

The financial crisis and the resulting regulatory reforms have created an environment of uncertainty for the global financial services institutions as they wait for final rules implementing the reforms. Currently, the regulators are in a process of assessment and deliberation around the rules for implementing the regulatory reforms enacted by the legislative bodies in the U.S. and Europe.

Post-crisis regulatory reforms have placed a number of constraints on business practices. One such constraint is the limits on debit card interchange.

Financial services institutions and intermediaries would be impacted differently once the new investor and consumer protection regulations are applied. Three key areas are expected to be affected:

4.1. Impact on the Current Business Models of Financial Services Institutions and Advisors

The emerging regulatory reform has placed explicit constraints on acceptable business practices of a number of sectors such as independent financial advisors and credit and debit card issuers. This will necessitate re-engineering of the business model to comply with the new regulations. Two of the most significant regulations that have placed explicit constraints on financial services institutions are the CARD Act in the U.S. and Retail Distribution Review in the U.K., which have abolished a number of existing business practices.

Debit card interchange has traditionally subsidized the cost of checking accounts in the U.S. This enabled banks to offer a number of services free of cost to their consumers. The Dodd-Frank Act disrupted the current business model by placing limits on debit card interchange.

Constraints placed on the existing business models will erode profit margins in the short-term. But, in the long term financial services institutions can overcome these challenges by applying a mix of traditional and innovative approaches to build margins:

- **Transparent Pricing of Services:** Financial services institutions will be forced to improve the transparency of their pricing model due to restrictions on traditional charging models such as provider commissions and high debit card interchange which subsidized financial advice and checking services.
- **Improved Consumer Targeting:** By accurately matching the needs of customers with financial products through the use of advanced analytics, financial services institutions can enhance customer loyalty.
- **Rationalized Spending:** By evaluating the cost of product and value generated by consumers, financial services institutions can choose to close programs that do not meet the profitability targets of the institution.

Leading banks in the U.S. have started charging for basic checking account services which were free of cost earlier to sustain profitability.

4.2. Greater Standardization of Retail Financial Products

The change in the regulatory environment is expected to drive greater standardization of financial products, especially for retail consumers. Standardization of financial products is expected to drive greater concentration and consolidation in the financial services industry as larger economies of scale mean better competitive positioning of the firm.

This trend is being primarily driven by the following three regulatory changes:

- **Expected Fall in Distribution Margin:** Regulatory initiatives such as Retail Distribution Review, and The Markets in Financial Instruments Directive II are expected to trigger a steep fall in distribution margin as they abolish the practice of commission payment to distributors. A recent survey of consumers by the Association of British Insurers showed that nearly 61%[2] of respondents did not want to pay for financial advice, which has limited the earning power of financial advisors. In this environment, providers are creating simple, easy-to-understand products which can be sold to the retail consumer with little effort.

- **Increased Fiduciary Responsibilities of Distributors:** A diverse set of financial intermediaries such as mortgage agents, broker-dealers, and financial advisors will be burdened with increased fiduciary duties by the Dodd-Frank Act to ensure that consumers are sold only products that are suitable to them. Financial intermediaries are expected to mitigate regulatory risk by promoting standardized products.
- **Standardization of Consumer Information Forms:** The process of standardization of consumer information forms mandated by the Dodd-Frank Act in the U.S and Undertakings for the Collective Investment of Transferable Securities IV in Europe has significantly reduced the differentiation between products in the portfolio. Due to diminished differentiation, financial institutions stand to gain by eliminating highly similar products.

The margins of financial services institutions are expected to shrink in the short-term due to increased competition aided by the consumer's ability to compare products with ease.

4.3. Increased Regulatory Burden

Since the crisis, regulators have taken a proactive regulatory stance. Legislators have significantly expanded their scope and purview by bringing previously unregulated entities under the regulatory umbrella.

This has resulted in an increased compliance burden for financial institutions. The three areas that are expected to drive compliance costs are:

- **More Frequent Reporting:** Regulators are asking for information more frequently from a diverse set of banking and non-banking financial institutions such as hedge funds, mutual funds, and money market funds to prevent concentration of risk. These changes are being driven by the new regulatory bodies created to monitor systemic risk such as the Financial Stability Oversight Council in the U.S. and the European Systemic Risk Board in Europe.
- **More Detailed Reporting:** The Federal Deposit Insurance Corporation in the U.S. and the European Banking Authority in Europe have been tasked with supervising banks. These regulators have significantly enhanced the detail of reports that must be published. The evolving regulations have empowered regulators such as the Security and Exchange Commission with authority to demand highly confidential information from hedge funds such as fund position, employees, investment strategy, and performance record. In the absence of a flexible and scalable IT system, collating the entire data is a tedious and time consuming job.
- **Increased Audits and Stress Testing:** Frequent audits and periodic stress tests are expected to become a standard fixture of the financial system. These tools have been found to be highly effective in identifying weak financial institutions. These audits and tests are expected to be run by the Federal Deposit Insurance Corporation in the U.S. and the European Banking Authority in Europe. Although these increased compliance obligations add to the costs of a firm, it assists firms in gaining greater visibility into their weaknesses.

[2] ABI Quarterly Consumer Survey 2010 Q4, Association of British Insurers, 2010

5 The Path Forward: Imperatives for Financial Services Institutions

Financial services institutions must meet the challenges posed by the evolving regulatory landscape with changes to current systems. Capgemini sees four key areas that financial services institutions must implement changes in the near-term:

5.1. Improve Reporting Infrastructure

Multi-agency supervision organizations such as the Financial Stability Oversight Council in the U.S. and the European Banking Authority in Europe are expected to require high quality data from financial institutions to perform their duties. To meet the data management and reporting demands of the regulators, financial services institutions will need to invest in strong and scalable information management and communication systems. These systems will provide the flexibility to meet both current and evolving data requirements of regulators.

5.2. Create a Robust Data Management System

The new regulations around the standard of care for investors and consumers places greater legal liability on the financial intermediary to prove that he has acted in the best interests of his consumer/ investor.

Financial services institutions need robust data management systems which enable executives to access accurate and up-to-date information regarding consumers and products essential to compliance with fiduciary standards. To comply with the standard firms will need robust technology that detects, tracks, and reports conflicts of interest.

5.3. Build Analytics-driven Multi-channel Consumer Relationship Management

Enhanced fiduciary standards require financial intermediaries across sectors to act in the interests of customers. In today's multi-channel world, it is an operational challenge to ensure compliance across all the channels used to communicate with the consumer.

Financial services institutions need a robust multi-channel customer relationship management system which can leverage consumer information to promote only the products that are suitable for the consumer and comply with the evolving regulations across all channels.

5.4. Increase Automation in the Compliance Department

To implement the Dodd-Frank Act, over 14 agencies in the U.S. will be creating nearly 240 rules over the next six months. Financial services institutions in other countries are likely to face a similar deluge of new rules. As the recent history of regulatory actions has shown, non-compliance will result in significant losses.

Financial services institutions will need to invest in robust rules-based systems to track compliance and pro-actively raise automated alerts before the rules are broken. Some possible features could be:

- Automatic tracking of investments in hedge funds and private equity funds
- Automated enforcement of fiduciary standards for retail broker-dealers
- Generation and maintenance of information around consumer investment objectives and risk appetite
- Automated report generation for mandatory reporting

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FINANCIAL SERVICES REGULATIONS

This series from Capgemini Financial Services provides information, research, and analysis on key regulatory and compliance topics for banks, capital markets firms, and insurers to help understand the impact of ever-changing government regulations across the globe. The series is written by our Strategic Analysis Group. Topics are divided into six broad themes:

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