



cutting through complexity

Financial Services Regulatory
Point of View

The Changing Face of Regulatory Reporting: Challenges and Opportunities for Financial Institutions

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Time to fix regulatory reporting – Regulators losing patience

Headlines surface almost daily that raise questions about the quality of the data financial institutions use in the reports they file with the regulatory authorities that form the basis of many of their public disclosures. Yet, these questions are not new and serve to highlight challenges that have been long-standing.

Recent news reports offer glimpses into the challenges financial institutions continue to face around producing core regulatory reports and highlight specific issues that still remain across the banking industry. These challenges include: (1) large numbers of manual reconciliations, (2) data integrity issues, (3) systems limitations, (4) analytical challenges, (5) resource and time constraints, and (6) governance weaknesses, including those pertaining to the “third line of defense.”¹

News reports have also revealed an increased severity in the tone adopted by regulators with respect to long-standing regulatory reporting findings. For instance, the tone of the joint press release issued by the Federal Reserve Board and the Federal Deposit Insurance Corporation on August 5, 2014, regarding the shortcomings in the 2013 resolution plans of the eleven largest, most complex banking organizations, was considered by many to be particularly harsh. More specifically, these agencies called out the industry’s lack of sufficient operational capabilities for resolution preparedness, such as “the ability to produce reliable information in a timely manner.”²

While a growing number of regulatory criticisms are directed at well-established reports, such as the FR Y-9C (Consolidated Financial Statements for Bank Holding Companies), new reporting requirements, such as the FR Y-14 (Capital Assessments and Stress Testing) and FR Y-15 (Banking Organization Systemic Risk Report), have compounded the issue, particularly

given the increased complexity of this new series. Additionally, more institutions are now under Federal Reserve oversight and will consequently need to develop the requisite processes, systems, governance, and data in order to file accurate and timely reports.

As regulators continue to place pressure on financial institutions to improve their reporting capabilities, strategic solutions will need to be developed that take into consideration the end-to-end process for the filing of regulatory reports. These strategic considerations should also be tied into broader regulatory mandates, such as the Basel Committee on Banking Supervision’s (BCBS) principles for effective risk data aggregation (RDA) and risk reporting.³

It is also important to remember that the financial crisis laid bare the inadequacy of risk data systems and processes, impeding the ability of banks and other financial intermediaries to manage risk, investors to confidently assess the accuracy and integrity of banks’ financial reporting, and regulators to mandate adequate liquidity provisions in order to limit contagion. Major market participants could not extract the necessary information quickly enough to understand the location and extent of risks and exposures, as investor confidence evaporated and markets seized.

More than six years later, the challenge remains as pressing as ever, and the regulatory authorities appear to be growing impatient with the industry’s lack of

¹ The “three lines of defense” model provides a construct for management control, risk control and compliance oversight, and independent assurance by defining clear roles and responsibilities within an organization’s wider governance framework. The “first line” includes operational management, the “second line” includes the risk management and compliance functions, and the “third line” includes internal audit. The Institute of Internal Auditors, *IIA Position Paper: The Three Lines of Defense in Effective Risk Management and Control*, <https://na.theiia.org/training/templates/Pages/The-Three-Lines-of-Defense-in-Effective-Risk-Management-and-Control.aspx>, January 2013.

² *Agencies Provide Feedback on Second Round Resolution Plans of “First-Wave” Filers*, <http://federalreserve.gov/newsevents/press/bcreg/20140805a.htm>, August 5, 2014.

³ Basel Committee on Banking Supervision, *Principles for effective risk data aggregation and risk reporting*, <http://www.bis.org/publ/bcbst239.pdf>, January 2013.

progress. Many financial institutions are simply failing to address the magnitude of the problems they face around RDA. We believe it is likely that the underlying cultural issue of who owns the data generally and who has responsibility for its quality and integrity is a key root cause for the industry's struggle to date.

Too often, risk data ownership is shuffled between the control and IT functions, with key business heads and senior management taking little direct responsibility. The industry needs to work towards a holistic

approach to data governance—not a siloed approach targeted at specific datasets required for individual directives. Risk data management cannot be solely about meeting regulatory requirements, but rather, it needs to address the more important cultural changes that are necessary if the industry is to view data management as the foundation for comprehensive, accurate, and timely reporting and, most importantly, harness its full potential for risk management and strategic planning purposes.

Examining the examination process

Regulatory reporting examinations are getting significantly more attention post-financial crisis. These examinations are customarily carried out by the Statistics Functions within the respective Federal Reserve Banks, although many of the newer reports, such as the FFIEC 101 (Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework), FR Y-14A (Capital Assessments and Stress Testing), and FR Y-15 (Banking Organization Systemic Risk Report), are being reviewed by examiners from the Supervision Functions within the respective Federal Reserve Banks.

As a part of the supervisory process conducted at these institutions, examiners seek to validate the filed balance in a given report's line item by tracing its data back to discrete transactions, such as an individual trade or a customer account. For example, examiners may review loan documents in order to validate that the slotting of the data into a particular category is correct on the basis of the loan's stated purpose, or inspect trade confirmations in order to verify certain trading activity. Examiners will also trace transactions through different

reports to ensure consistency is achieved at both the parent and subsidiary levels. In addition, examiners will review all workpapers used to prepare the reports in scope, which requires banks to clearly document all processes, including explanations for manual adjustments, in order to avoid unwanted criticism.

Accordingly, preparation for these reviews is a substantial undertaking, as the data requests require end-to-end mapping that often results in tens of thousands of pages of documentation that must be prepared in advance of the examination start date. For most institutions, these reports require significant coordination between lines of business, who are the data users and providers, and the regulatory reporting filers. This is critically important and an ongoing area of concern, as the report filers do not necessarily have a clear line of sight into the source data and the data providers often do not fully understand the reporting parameters and definitions. This frequently results in misinterpretations around what exactly needs to be provided to the regulators for a given line item.

In conducting exams, the Federal Reserve Board and the respective Federal Reserve Banks will typically assess an institution's policies and procedures, processes, systems, data, and governance as a part of the supervisory review of accuracy. While most institutions rely on significant manual processes and resultant reconciliations in their report preparation process, the Federal Reserve, and regulators more generally, have become less tolerant of an over-reliance on manual solutions and "work-arounds," especially in instances that lack sufficient oversight and documentation. In addition, materiality is often not factored into the examination process for various reports, resulting in regulatory findings for errors that may be immaterial when compared to the size of the institution's overall balance sheet. Management must also prepare for the possibility that the institution's regulatory reporting examination may expand to cover more traditional safety and soundness-related control issues, which may then be identified as part of the original regulatory reporting exam.

The stress testing regimes, such as the Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR), and the resultant reports that need to be filed, create an additional layer of complexity for institutions. Specifically, the scope, volume, and granularity of data that banks are now required to submit to the regulatory authorities seems to represent a sea change in the way that financial institutions are regulated. Indeed, at the Federal Reserve Board's Third Annual Stress Test Modeling Symposium, Governor Daniel K. Tarullo stated that, "supervisory stress testing and the associated review of capital planning processes have provided a platform for building out a regulatory framework that is more dynamic, more macroprudential, and more data-driven than pre-crisis practice."⁴

For larger, more complex institutions, regulatory reporting examinations represent very detailed assessments of the accuracy of the institution's regulatory reporting processes, based on a thorough assessment of a range of reports. In addition to the FR Y-9C consolidated financial statements for bank holding companies, in-scope reports, for example, may include:

- FR Y-9LP (Parent Company Only Financial Statements for Large Bank Holding Companies),
- FR Y-10 (Report of Changes in Organizational Structure for Bank Holding Companies),
- FR Y-11/FR Y-11S (Financial Statements of U.S. Nonbank Subsidiaries of U.S. Bank Holding Companies),
- FR Y-12 (Consolidated Bank Holding Company Report of Equity Investments in Nonfinancial Companies),
- FR 2314/FR 2314S (Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations),
- FR 2900 (Commercial Bank Report of Transaction Accounts, Other Deposits, and Vault Cash), and the
- FFIEC 041 (Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only).

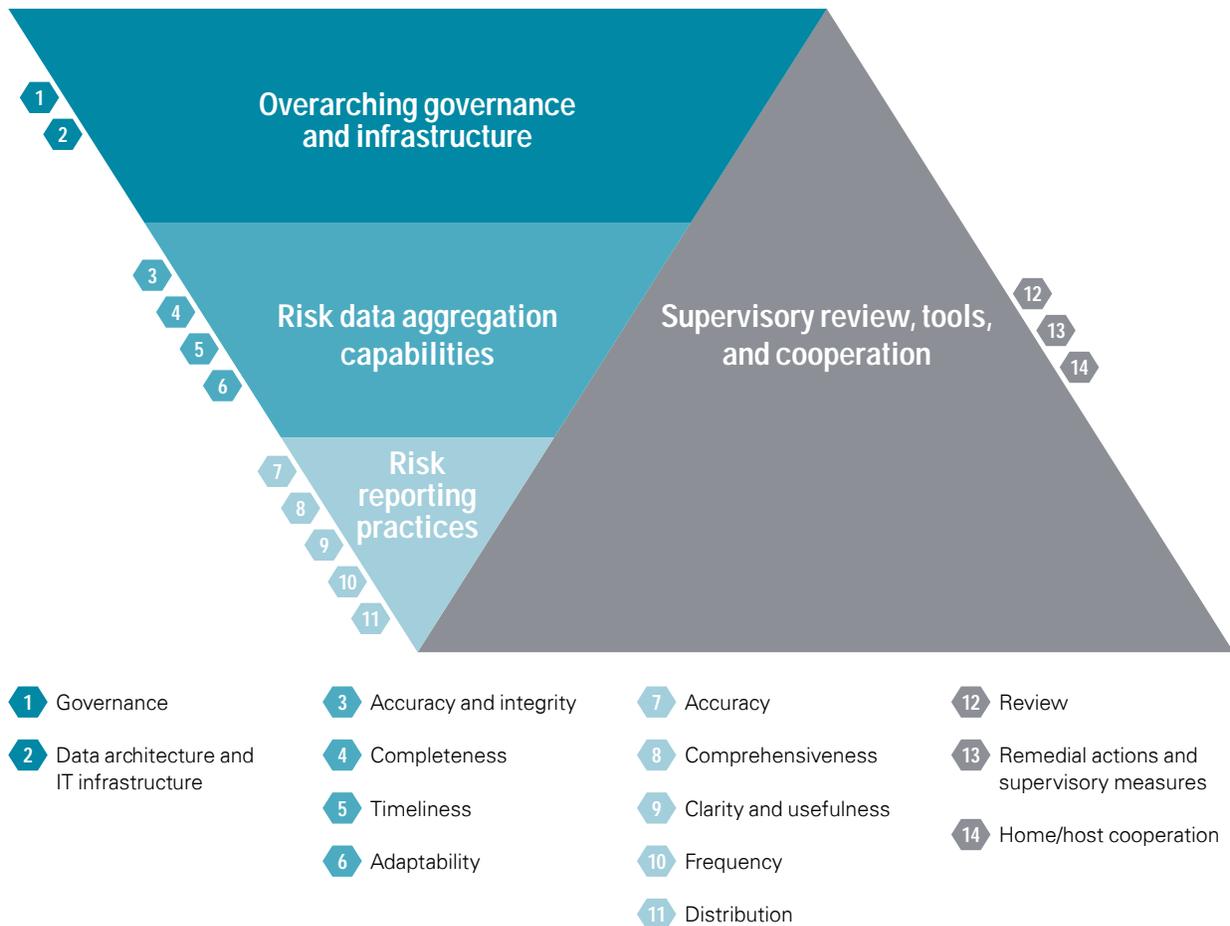
⁴ At the Federal Reserve Third Annual Stress Test Modeling Symposium, Boston, Massachusetts, <http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm>, June 25, 2014.

Where to start when tackling the data dilemma

As enhanced data quality, reporting, and management requirements gain more prominence and their role in capital management intensifies, the industry would be wise to pay more attention to this key area. In 2009, the BCBS issued guidance designed to enhance banks' ability to identify and manage firmwide risks,⁵ and in 2013, the BCBS published a set of principles, illustrated in Figure 1, aimed at strengthening RDA capabilities and internal risk

reporting practices at banks, along with guidance on the principles' implementation.⁶ Although these principles, which apply at both the group level and all material business units and entities within the group, are initially addressed to the largest, most systemically important and globally interconnected banks, national supervisors have already signaled that they plan to apply the principles to a wider range of financial institutions in the future.

Figure 1:
The fourteen BCBS principles for effective RDA and risk reporting



⁵ Basel Committee on Banking Supervision, *Enhancements to the Basel II framework*, <http://www.bis.org/publ/bcbs157.pdf>, July 2009.

⁶ Basel Committee on Banking Supervision, *Principles for effective risk data aggregation and risk reporting*, <http://www.bis.org/publ/bcbs239.pdf>, January 2013.

In January 2014, the Office of the Comptroller of the Currency (OCC) released a proposal setting forth new standards, based on the agency's heightened expectations program, for large national banks and federal savings associations. In the proposed guidelines, the OCC stated that it expects the global systemically important banks (G-SIBs) it supervises to be "largely compliant" with the BCBS principles by the beginning of 2016, and that other banks under the OCC's purview, while not expected to comply with the principles by the same deadline, should nevertheless view the principles as leading practices and make an effort to bring their practices into alignment with the principles wherever possible.

Similarly, the Financial Industry Regulatory Authority (FINRA) recently issued a "concept proposal" to develop a new, rule-based program called the Comprehensive Automated Risk Data System (CARDS). This system would impose new investor account reporting requirements on brokerage firms and allow FINRA to collect account information on a standardized, automated, and routine basis. Once implemented, FINRA envisions analyzing

CARDS data before examining these firms on-site, thereby potentially identifying risks earlier and shifting work away from FINRA's traditional on-site exam process towards off-site continual monitoring. This trend will likely continue, as regulatory authorities build their proficiency in collecting and analyzing these data and move towards a real time, "bird's-eye view surveillance" model.

Reporting requirements for the Securities and Exchange Commission's (SEC) Consolidated Audit Trail are also on the horizon for these firms. Adopted by the SEC in 2012 in response to the 2010 "Flash Crash," this system will require broker-dealers to accurately identify and report every order, cancellation, modification, and trade execution for all exchange-listed equities and equity options across all U.S. markets in a uniform manner, thereby allowing the SEC to use these data to conduct cross-market supervision of firm trading activities.

Regulators are trending towards a "bird's-eye view of surveillance" model.

Focus of supervision has changed dramatically

After the introduction of the Supervisory Capital Assessment Program (SCAP) in the spring of 2009 helped to stabilize the U.S. financial system, supervisory stress testing has become a cornerstone of the Federal Reserve Board's approach to the regulation and supervision of the largest financial institutions.⁷ The SCAP and the subsequent CCAR also centralized the supervision of these institutions at the Federal Reserve Board, and CCAR's incorporation of macroeconomic scenarios

broadened the role of Federal Reserve Board economists who were previously involved solely in monetary policy by incorporating their analysis and viewpoints into the supervisory process. As a result, the CCAR process has since been integrated into ongoing regulatory supervision, with the Federal Reserve Board signaling that CCAR will become an integral part of its year-round supervision, rather than a discrete, annual exercise.

⁷ Other countries have since followed suit, as most BCBS members are now conducting some form of stress testing. Basel Committee on Banking Supervision, *Peer review of supervisory authorities' implementation of stress testing principles*, <http://www.bis.org/publ/bcbs218.pdf>, April 2012.

Banks struggling to meet the data challenge

In December 2013, the BCBS published a review of banks' progress toward implementing the principles, which included a self-assessment questionnaire completed by G-SIBs.⁸ The results of the self-assessment showed that, broadly speaking, the principles related to risk reporting practices had higher reported levels of compliance than the principles related to overarching governance and infrastructure and RDA capabilities. Nearly half of the G-SIBs reported material noncompliance with their data architecture/IT infrastructures' adaptability, accuracy, and integrity, with many banks reporting that they were facing difficulties in establishing strong data aggregation governance, architecture, and processes. To compensate, banks reported that they are resorting to extensive manual work-arounds that are likely to impair their RDA and reporting capabilities.

The anomaly of the risk data reporting principles rating higher than those principles related to governance/infrastructure was cited as "difficult to interpret" by the BCBS, as these principles are considered foundational to ensuring compliance with the other principles.⁹ Similarly, the BCBS noted that a few banks rated themselves as fully compliant on the comprehensiveness principle, but rated themselves materially noncompliant on one or more of the data aggregation principles, raising concerns about the reliability and usefulness of their risk reports when the underlying data informing them and the processes to produce them have such significant shortcomings.

This self-assessed lack of progress against most of the principles is telling and is not likely to improve dramatically, as the deadline to comply by the beginning of 2016 is fast approaching.

Supervisory expectations for data continue to mount

The integration of the CCAR process into ongoing supervision has also increased the oversight function of Federal Reserve Board staff. It is noteworthy that during his speech at the Third Annual Stress Test Modeling Symposium, Governor Tarullo announced that a "committee chaired by senior Board staff that is responsible for the oversight of CCAR, supported by the relevant horizontal assessment teams, will directly engage with firms during the course of the year to evaluate progress in remediating weaknesses or other issues identified in the post-CCAR letters."¹⁰ This is an important new development, further centralizing and strengthening the role of the Board in the overall

supervisory process, and lessening the role played by staff at the Federal Reserve Banks.

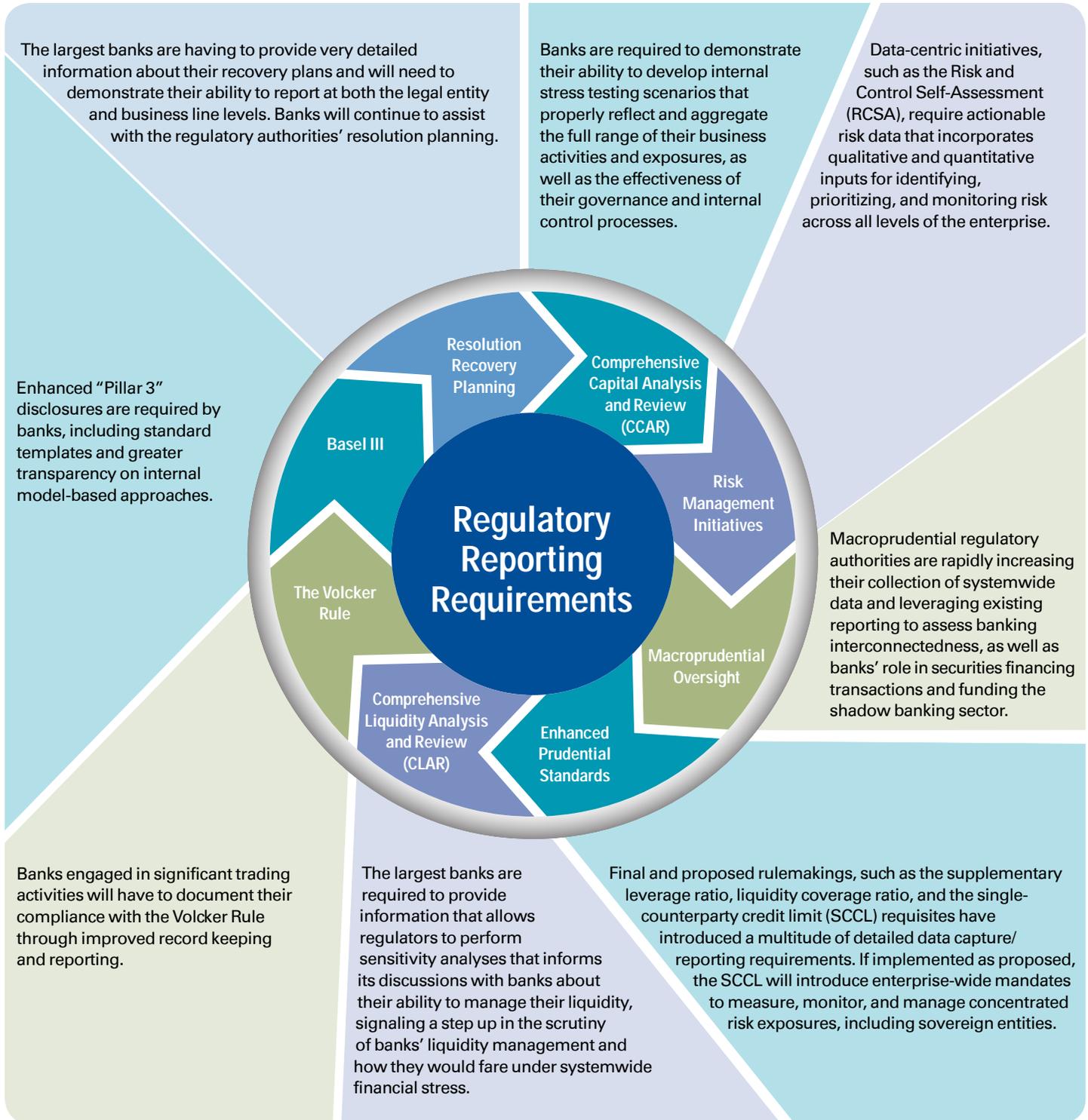
While CCAR is certainly data intensive, it is not the only new reporting requirement in the post-crisis supervisory world, as Figure 2 demonstrates. Indeed, it is often difficult to maintain an accurate account of the ever increasing number of new data reporting requirements, particularly when *ad hoc* requests from the regulatory authorities are added to the mix. Yet, it is very likely that regulators will be actively assessing whether banks' data architectures and IT infrastructures are capable of supporting the myriad of new reporting requirements.

⁸ Basel Committee on Banking Supervision, *Progress in adopting the principles for effective risk data aggregation and risk reporting*, <http://www.bis.org/publ/bcbs268.pdf>, December 2013.

⁹ Ibid.

¹⁰ *At the Federal Reserve Third Annual Stress Test Modeling Symposium, Boston, Massachusetts*, <http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm>, June 25, 2014.

Figure 2:
Regulators will be assessing whether banks' data capabilities can support ongoing stress testing and new reporting requirements



These enhanced expectations and additional oversight requirements are being mandated as the industry continues to feel pressure from regulators for improved data and reporting enhancements. In reviewing the regulatory findings that have been posted publicly, it is evident that the tone that is currently being taken during these supervisory reviews has changed in recent years. Given the recent deluge

of headlines focusing on data concerns, it does not appear that this trend will abate anytime soon. In fact, this pressure will likely only intensify, as institutions are required to not only conduct additional stress testing on a more frequent basis, but also make their processes around data production and reporting documentation more transparent.



Key challenges to meeting heightened regulatory expectations

Legal entity reporting is posing a strategic challenge for banks, as the number of reports has increased exponentially against a fixed revenue line. Banks are also experiencing difficulty when trying to integrate legacy systems that have resulted from various mergers and acquisitions.

For most financial institutions, data quality remains an ongoing challenge, with its integrity degraded by inconsistent taxonomies, inaccuracy, incompleteness, and duplication. With poor quality data, the effectiveness of risk management can be seriously compromised. Datasets also typically reside in different silos that are often owned by different functions, all with different incentives, attitudes, and approaches to managing data.

For many organizations, their reporting architecture is a patchwork of data extraction, manual calculation, and reporting components that is focused on individual reports by business area. This rarely allows for the calculating and reporting of risks across legal entities, geographies, or by product mix, and may not easily facilitate the *ad hoc* analysis or the granularity needed to understand emerging trends or issues. Plagued by multiple, discrete systems and possibly incompatible, inconsistent datasets, risk professionals spend too much time and effort on data aggregation, reconciliation, and manual adjustments and too little time on analyzing and applying the results in order to achieve better risk management and decision making.

As financial institutions refine their processes around data management, a true test of a successfully implemented data architecture and IT infrastructure will likely come in the form of a scenario or stress test that requires these institutions to respond to an impromptu regulatory request for certain information. This will allow regulators to determine whether the banks' self-assessments are consistent with the information they are able to produce on demand. However, meeting this test in a timely fashion would likely pose a challenge for most firms today. Indeed, as the shortcomings in the resolution plans made clear, regulators continue to be concerned about the industry's ability to produce reliable information on demand.

Regulators will likely expect on-demand reporting capabilities at all material entities and levels of the enterprise.

A way forward

Regulatory reporting scrutiny is expected to continue, and with a number of firms struggling to meet the BCBS 2016 deadline, it is clear that RDA will only grow as a regulatory focus and challenge for ensuring accurate and timely filings. Along with it, reporting complexity will increase exponentially with mandates, such as CCAR, Resolution Recovery Planning, Volcker, Liquidity, and Basel III, continuing to raise the bar for banks.

Expectations around independent data validation, including whether this validation can come from internal audit or a third party, also need further clarification from regulators. In addition, the oversight of third parties assisting firms with their regulatory report filings continues to be examined closely and adequately monitoring these activities may require further enhancements to firms' IT infrastructures.

The types of reporting weaknesses being identified by regulators provide some insights into the areas of supervisory focus in the coming years. Firms will need to ensure that the scope and robustness of their reporting encompasses not only the group level, but also takes into account each material business unit or entity within the group.

Expectations around independent data validation, including whether this can come from internal audit or a third party, will need further clarification from regulators.

Financial institutions will also need to quantify, aggregate, and report all types of material risk, such as liquidity and operational, in a more comprehensive manner, as covering credit and market risks alone will likely no longer be sufficient. Additionally, clearly articulating risk tolerance levels for manual adjustments versus automated processes for data aggregation and reporting will be critically important going forward. Lastly, achieving compliance with the BCBS principles related to governance will set an iterative process in motion that will yield improved data quality and reporting usefulness that will evolve as the institution evolves, develops new products, and conducts new business.

In enhancing its regulatory reporting processes, management will need to consider both the strategic-level initiatives that have natural linkages with reporting, such as RDA and regulatory change management initiatives, as well as more tactical solutions. While these strategic initiatives will support the program in the longer term, management should not lose focus on the importance of other tactical initiatives, such as tightening governance, increasing training, and effectively preparing for examinations. Overall, we believe that the current regulatory reporting regime requires far more attention and resources than ever before, and like other key initiatives, the risks of getting it wrong are now the highest they have ever been.





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