



Trust but Verify: Compliance in a Regulated World

by **Dr. Jim Goodnight**

Two-hundred-fifteen years ago, U.S. statesman Benjamin Franklin wrote, “In this world nothing can be said to be certain, except death and taxes.” Were Franklin alive today, he no doubt would have extended the sentence to include the word “compliance” as well. Government regulations, and compliance to them, constitute one of the biggest issues facing organizations today: corporate governance.

In early 2004, I had the privilege of moderating a panel titled “Regulation with Innovation in Mind” at the World Economic Forum in Davos, Switzerland. We discussed a range of issues, across industries and within the public sector, and found a critical common denominator: balance. With too much regulation, innovation is stifled; yet with too little regulation, the people whom the regulators represent face increased risk. And “risk” can mean many things, including money, health, freedom and confidence.

Regulations are usually imposed by government or by industry group in response to someone tipping the balance. The correct amount of legislation re-creates the needed balance while overlegislation can tip it in the other direction. The severity of the event usually has a lot to do with the amount of legislation imposed. For example, the well-publicized “corporate mischief” of companies like Enron and WorldCom led to the passing of the Sarbanes-Oxley Act.

The federal government has also recognized the need to address “consumer mischief.” The U.S. Fair and

Accurate Credit Transactions Act of 2003 (the FACT Act of 2003) extends the Fair Credit Reporting Act (FCRA) passed in 1970. The goal of the FCRA was to support the accuracy, fairness and privacy of personal information collected by consumer reporting agencies. The FACT Act of 2003, however, also addresses the problem of identity theft.

Besides corporate and consumer mischief, there are times when acts committed by a third party are of such severity that new regulations are required. For example, the Sept. 11, 2001, terrorist attacks that severely damaged the U.S. Pentagon and destroyed the Twin Towers (and thousands of innocent lives) led to the creation of the Department of Homeland Security and the passing of the USA PATRIOT Act.

Today in the financial services industry, many regulatory buzzwords, such as Basel II, HMDA (Home Mortgage Disclosure Act) and SOX (Sarbanes-Oxley Act), have become part of our business vocabulary. And they were all created to correct an imbalance or to ensure an existing balance.

Basel II

The first Basel Capital Accord was created in 1988 because the governors of the Group of Ten (G-10) central banks were concerned that the world's major banks were undercapitalized. (The Group of Ten is made up of 11 industrialized countries — Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States — which consult and cooperate on economic, monetary and financial matters.) The G-10 feared a repeat of the Latin American debt crisis (which was caused by several

things, including a catastrophic depletion of foreign currency reserves). The accord addressed this issue by recommending that banks have a minimum level of capital, which they carefully defined in terms of types of assets and how risky those assets were. Within two years, the accord's banking framework had been adopted by banks in more than 100 countries.

But the financial services world is constantly changing, with new products and new ways of looking at risk. With all these changes, a bank could adhere to the Basel Capital Accord and still be undercapitalized. So, the Basel Committee began a series of discussions with banks and experts in the world banking community on the need to better identify and assess risk.

In January 2001, the Basel Committee on Banking Supervision issued its new 500-page proposal for identifying and assessing risk, the New Basel Capital Accord or, as it is commonly known, Basel II.

There are three major components to Basel II: minimum capital requirements, supervisory review and market discipline. The goal of these components is to diminish overall risk (both credit and operational) by ensuring not only that companies have enough capital but that they better assess actual risk. Basel II requires companies to better report how well capitalized a bank is as well as to disclose the processes and procedures by which those values are derived. Basel II is still in development and is expected to be fully adopted by 2006.

The overall goal of regulations like Basel II is to identify financial institutions that have the highest risk of failure. To do this, banks need to be able to accurately report assets and risk. We've been working with many banks

BankWest Chooses SAS® Credit Risk Management for Basel II Compliance

BankWest is one of Australia's most innovative banks and wants to take advantage of its compliance with the stringent new Basel II banking regulations to give it an edge over its competitors.

Following a rigorous tendering process, BankWest has chosen the SAS Credit Risk Management solution. It was important for BankWest to choose the right vendor; the wrong solution could not only jeopardize its compliance with the international banking regulations, but also require it to pay more for its funding.

The SAS Credit Risk Management solution will help BankWest meet the requirements of all "three pillars" of Basel II. These relate to the roles of the bank itself, the national regulator (in this case, APRA) and the market (through credit ratings agencies such as Moody's and Standard & Poor's). The SAS solution allows BankWest to calculate and aggregate market and credit risk measures to ensure transparency and comparability. It also lets BankWest improve its capital allocation and optimize its risk-reward profile. ■

in Europe and around the world to do this type of risk assessment. For example, we helped one major Italian bank bring all its consumer data together and, using high-end analytics, we were able to create an extremely accurate understanding of its credit risk. In addition, SAS created a credit data warehouse to ensure an ever-deeper knowledge of borrowers and a credit risk management model to comply with Basel II requirements and to strengthen the bank's competitive edge. Using this method of analysis, the bank was able to

better identify its most (and least) risky customers and to easily comply with Basel II.

USA PATRIOT Act & Anti-Money Laundering

With the passing of the USA PATRIOT Act shortly after the Sept. 11, 2001, terrorist attacks, the world spotlight turned to money laundering and terrorist financing. Money laundering is the process of erasing the pedigree of the proceeds from a variety of crimes – including fraud, racketeering, the sale of drugs and illegal arms – and reintroducing it into financial systems as legitimate capital. Money laundering is one of the world's oldest "professions," according to Sterling Seagrave in his book *Lords of the Rim*. In the book, Seagrave writes about businessmen in ancient China who would steal from government warehouses and then launder the illicit gains:

"They invested secretly in merchant ventures, paying for a ship, a barge, a caravan, or a pack train. In this way they became brokers of luxuries imported from distant places, including gems and pearls, carved ivory decorative objects, hardwoods, aromatics, and aphrodisiacs."

(Lords of the Rim: The Invisible Empire of the Overseas Chinese, Sterling Seagrave, 1995, New York, G.P. Putnam's Sons, p. 17.)

Using their new, "legitimate" wealth, the businessmen were able to wield greater political influence.

In the United States, it wasn't until 1986, and the passing of the Money Laundering Control Act (which extended the reporting regulations of what was called the Bank Secrecy Act of 1970), that certain financial transactions with proceeds generated through specified unlawful activities – such as narcotics trafficking, Medicare fraud and embezzlement, among others – became crimes.

Working with the Regulators: The U.S. Department of Homeland Security

The Department of Homeland Security was officially established in January of 2003 to prevent and to respond to an increased threat of terrorism following the wake of the Sept. 11 attacks. The National Strategy for Homeland Security and the Homeland Security Act of 2002 mobilized and organized the U.S. to help secure the nation from possible terrorist attacks. To be successful with this incredibly complex mission, the Department of Homeland Security provided a unifying center for the vast network of organizations and institutions involved in these efforts.

The Department of Homeland Security consists of 22 agencies: the Departments of Agriculture, Transportation, Treasury, Justice, Defense and others. The goal of the organization is to prevent and deter future terrorist attacks and threats to our nation by ensuring safe and secure borders while remaining open to visitors and immigrants, and promoting the free flow of commerce. With scrutiny coming from the president, Congress, press and public, the stakes are high for this department.

SAS has been working with several bureaus within the Department of Homeland Security – such as Customs and Border Protection, Immigration and Customs Enforcement, and the Coast Guard – to help managers, agents and officers pull together large amounts of complex data, make that data reliable and gather operational intelligence to facilitate sound decisions. In addition, SAS has been working with the Resources Management Integration Office, the body tasked with integrating the people, processes and technologies used by these 22 agencies, to help enhance the effectiveness of the department while finding better, more cost-effective ways of operating. ■

With the enactment of the USA PATRIOT Act (Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001) came additional anti-money laundering legislation. The act required that financial services providers administer new programs and new reports, including:

- Training programs and policies with executive sponsorship.
- Policies and processes to facilitate the communication between financial institutions, regulatory agencies and law-enforcement agencies.
- Programs to monitor and analyze financial transactions and detect possible money laundering activities.

Today, financial services organizations are using both traditional business intelligence and advanced analytics to augment investigation efforts and facilitate the process of compliance. Unlike initiatives that are primarily ROI-focused, the fight against money laundering and terrorist financing delivers a more intangible return: reputation and brand equity, shareholder value, and contributions to the greater effort of security.

Home Mortgage Disclosure Act

Regulations and laws are often created to ensure that businesses operate in a manner that is consistent with fundamental principles of ethics and social responsibility in order to protect consumers, and whole communities, from any/all forms of exploitation or mistreatment. The Home Mortgage Disclosure Act (HMDA) was passed by Congress in 1975 to require lending institutions (banks, savings associations, credit unions, etc.) to provide the public with loan information that can help individuals, communities and public officials assess the degree to which lenders are serving housing needs to identify

Unlike initiatives that are primarily ROI-focused, the fight against money laundering and terrorist financing delivers a more intangible return: reputation and brand equity, shareholder value, and contributions to the greater effort of security.

where public sector investment is needed to attract private investment, and to identify suspected discriminatory lending patterns. The Community Reinvestment Act (CRA), passed two years later, spelled out how a financial institution's obligation to meet community needs would be assessed via lending, investment and service tests. Over decades, HMDA has been amended to expand the scope of data to be filed, while immigration patterns and population migration trends have contributed to revisions of metropolitan statistical areas and are reflected in new socioeconomic and ethnic compositions at the census-tract level.

Amidst all of the regulatory, economic and demographic change, financial institutions have struggled to capture and analyze their lending performance effectively and efficiently and report it in the most accurate and timely manner possible. These institutions want the assurance that they are not only complying with the letter of the law, but that they also fully understand their track record, know what potential exists to extend their goals in meeting the needs of their customers and the communities in which they operate, and have the ability to put plans into motion that will enable them to achieve both tactical and strategic objectives.

In the past few years, changes to HMDA have aimed beyond the goal of fully understanding who gets approved for a real estate secured loan, to knowing how much borrowers are paying for specific types of loans in different geographic markets under a variety of circumstances. This has been done with the goal in mind of fostering parity by identifying and correcting even small imbalances. In the summer of 2005, with the release of additional new HMDA data, the full range of constituencies will seek to better determine not only if, but also how, lending institutions are meeting their community's housing credit needs and whether or not regulatory enforcement efforts need to be stepped up.

With the 2002 amendment to HMDA, the new data capture requirements effective in 2004, and the subsequent reporting of new information in 2005, there is a renewed focus on HMDA. For example, some financial institutions are creating comprehensive solutions that streamline and automate as many HMDA reporting processes as possible – equipping compliance executives with the tools to meet strategic objectives.

Sarbanes-Oxley Act

Until 2001, only investors and people in the energy

business paid much attention to Houston-based Enron. It was considered to be a model company, touted as “America’s Most Innovative Company” for five years in a row by *FORTUNE* magazine and considered to be as stable as the world’s need for energy.

But Enron’s business model was far from simple. As the broker of energy commodity sales, the company offered an increasing variety of options to its customers. For additional fees, customers could protect their investments against everything from interest rates to changes in the weather. According to the company, it brokered a staggering \$880 billion in energy commodities over two years. And as the broker, the company made money from every transaction.

Enron had discovered the perfect business model, and it handsomely rewarded its CEO (a half-billion-dollar package, including compensation of \$53 million, \$123 million in exercised options and \$361 million in unexercised options). The company was a shining example of corporate America and even of capitalism itself.

To fully leverage its position as a wholesale energy trader to grow the company, Enron borrowed money. Not all of this new debt showed up on its balance sheets and, with strong investor confidence, Enron’s stock price remained high.

But all that changed on Oct. 16, 2001, when Enron reported a third-quarter loss of \$618 million, and the house of cards collapsed. Within three months, Enron went from being a company with assets of more than \$63.3 billion to bankruptcy, its stock price plummeting from a high of more than \$90 to less than a dollar per share.

Enron had been misrepresenting itself to its investors by concealing debts and inflating profits. By creating shell companies, which Enron executives managed, the company was able to hide a lot of debt for which it was responsible. The company’s problems were hidden by a façade, and everyone had been fooled. Once the true nature of Enron’s assets was known, investor confidence dropped, resulting in a significant decrease in the value of Enron stock and a lowered credit rating.

The fallout from Enron also ripped off the false front of other companies whose reporting processes were questionable, including Global Crossing, WorldCom and Tyco, to name a few. There was an imbalance, and it needed correcting.

On July 30, 2002, Congress signed into law the Sarbanes-Oxley Act of 2002, considered to be the most significant change to federal security laws since the New Deal. Sarbanes-Oxley (also known as Sarbox or simply SOX) makes senior executives responsible for creating and monitoring internal controls over financial reporting and disclosure. SOX also requires that senior executives personally certify that these disclosures — and the processes used to derive them — accurately reflect the company’s financial state.

When this law was passed — with its many sections — many software companies scrambled to create products and solutions to sell to corporations. We found that even though SOX was a new regulation, it was still a matter of regulated bodies (corporations) gathering data, analyzing that data, and reporting that data to meet the specifications of the regulation. SAS had already created technology for our customers in the pharmaceutical industry to track new drugs through

the U.S. Food and Drug Administration approval process. So to meet the specifications for SOX, we added financial industry capabilities, such as components for operational risk, financial consolidation and reporting, and a digital signature certification hierarchy.

Trust but Verify

Financial services companies have always been on the leading edge of technology, because technology facilitates processes which, in turn, generate higher revenues. Regardless of the market or whether the value of equities rises or falls, companies that manage the transactions — extend credit or limit risk through insurance and reinsurance — make money. And several changes in the recent past, including the globalization and deregulation of the financial services industry, have brought the industry to new levels of complexity and have caused a geometric rise in the number of transactions and activities. This activity has brought increased attention to the financial services industry by regulatory bodies, which argue that without oversight, the collapse of a single large financial organization could start a domino effect and wreak havoc on the world economy.

There are really two balancing acts going on at the same time: the balance between the parties that have a common interest (corporation/investor, financial institution/account holder) and the balance between the regulator and the regulated (U.S. Securities and Exchange Commission/U.S. corporations, Basel II Committee/European Union financial services companies). When asked in late 1987 whether he thought the Soviet Union would live up to its agreement for nuclear disarmament, U.S. President Ronald Reagan replied, “I think I could sum up my position on this with the

recitation of a brief Russian proverb, ‘Doveryai no proveryai.’ It means trust but verify.”

In today’s world, safety, security and confidence require verification, but without a balance, innovation will face, in the words of another Russian proverb, “Suffocation by embrace.” ■

BIO:

Dr. Jim Goodnight is president and CEO of SAS.