
In this edition, Willis experts consider the unintended consequences of financial regulation and focus in on the SEC’s increasingly robust approach to the asset management industry. We then highlight Willis’ 1-in-100 Initiative, work by an alliance of international bodies including the United Nations to integrate natural disaster and climate risk into financial regulation globally. We also examine the impact of local events on firms which operate with a global footprint.

I’m also pleased that we have a guest publication from alva, a firm which specialises in providing reputation business intelligence to companies, to explore the developing area of reputational risk management and advice.

I hope you find this newsletter informative. Please contact me or your usual Willis representative if you’d like to share your thoughts and feedback or if you’d like further information about how FIG can work with you.

Thank you for your time.

Mary O’Connor
CONTENTS

Four Unintended Consequences of Post-Crisis Regulation ................................................................. 4
Climate Risk and Investment – The 1-in-100 Initiative ...................................................................... 6
Are you ready for (SEC Enforcement) action? ....................................................................................... 8
Risking it all: Reputation Matters Now More Than Ever ................................................................. 10
Operating with a Global Footprint – Out of Sight, Out of Mind? ................................................... 12
Since the financial crisis, governments have made wide-ranging changes to the way financial institutions are regulated. In particular, regulators have focused on the amount and type of capital that banks and other financial institutions must hold, and set new standards as to how they must interact with consumers and markets. This has given rise to a number of unintended consequences, which have far-reaching impacts on financial institutions and the wider economy. Worryingly, regulators seem to lack the tools to address these challenges.

1. Less Lending

First, banks have been required to increase levels of capital and reduce the amount of leverage on their balance sheets. Changes, intended to improve the resilience of banks and the economy as a whole, have instead encouraged banks to cut back on lending to key sectors and industries. Non-bank financial institutions have stepped in to plug the gap. This shift will continue unless incentives change. In the meantime, regulators need to establish new ground rules to ensure that all lenders (not just banks) have appropriate levels of capital and operate to the same high standards of conduct towards customers.

In the aftermath of the crisis, regulators cracked down on high-risk activities by increasing the capital required to offset them, and enhancing the penalties for unacceptable conduct. As a result, many banks have reduced or divested themselves of proprietary trading and other “high risk” activities. JP Morgan sold its commodities business the day after it was declared the world’s top commodities bank, having concluded that the business was not worth the capital or regulatory risks. The business was subsequently sold to Swiss commodities trader Mercuria. Deutsche Bank, Bank of America and Barclays have either exited or are planning to exit the commodities business. It is likely that these businesses will be snapped up by firms not subject to stringent banking requirements.
2. More Shadow Banking

This brings me to the second unintended consequence. As regulation causes banks to deleverage balance sheets, increase capital and withdraw from certain activities, the shadow banking system is expanding to take advantage of new opportunities. Recent estimates place the growing shadow banking sector at $71.2 trillion. At present, regulators appear content to allow this growth to continue, provided it does not negatively impact retail bank consumers.

Over the long term, this strategy may be insufficient. As the role of non-banks increases, and as their activities become more intertwined with the wider economy, regulators may want to have more oversight over the riskiest transactions, not less. As the financial world undergoes this paradigm shift, regulators and regulation will need to keep pace.

3. Regulation-Driven Trades

Regulations around risk-weighting of assets and capital are responsible for the third unintended consequence. Some banks have been prompted to undertake trades solely to ameliorate the effects of regulation. A major European bank reported that it lost €94m in the first half of 2013 on credit default swap positions that were being used to reduce Basel III capital requirements for the purposes of calculating the bank's credit valuation adjustment, but which would not normally be required for economic hedging purposes. The loss resulted from a disparity in the way regulators and accountants treated the hedges.

Other banks are engaging in transactions to transfer the risk of assets to third parties to improve their regulatory capital position. Such deals have proved lucrative for some parts of the shadow banking sector. It is certain that, in the near term, the regulatory environment will encourage banks to engage in further transactions to reduce capital drag on their balance sheets—regardless of the economic value created. Regulators will need to carefully draft legislation to ensure consistency and reduce incentives for non-economic arbitrage.

4. Banking Brain Drain

Stress, strain and brain drain is the fourth unintended consequence. Regulatory pressure, increased scrutiny (including an enhanced possibility of personal liability) and bonus caps have driven experienced individuals out of traditional banking. The risk-reward trade-off is changing. Politicians have strengthened pay codes to limit bonuses and impose substantial rights of clawback over payments to executives. The FCA has also been granted new powers to prosecute top executives.

Employees outside the C-suite are also feeling the heat. Bank workers—who already work long hours—have more intensive training, complete additional compliance reviews, and fill out more paperwork, even though their workload has risen due to redundancies. Stress is a genuine problem. The Bank Workers Charity found that 60% of bankers suffer from poor sleep quality and job-related stress. Increased levels of stress can lead to absenteeism. 50% of long-term absence in non-manual work is reportedly due to stress—with absenteeism in the UK costing £29bn.

It cannot have been the regulators’ intention to drive experienced individuals away from banking, or to reduce the resilience of financial institutions. Regulators need talented people within financial institutions to embed regulatory changes and create the cultural shift necessary to restore faith in finance. Regulators should consider the “people resilience” of organisations, to develop new ways of encouraging institutions to conduct themselves in ways that are beneficial to the economy.

This article was originally published in City A.M., August 11, 2014.

November 2014
Economies, industries and communities face increasing threat from climate change, its risks and impact. We are all too familiar with the devastation caused by natural disasters, from property damage to the tragic loss of lives. The UN Climate Summit, which took place in New York in September, addressed these issues by raising political momentum and mobilizing action to reduce greenhouse gas emissions and build resilience to climate risk, ahead of next year’s key climate change negotiations in Paris. The Climate Summit brought together an unprecedented number of world leaders, from business, finance and civil society, to agree actions that will address some of the challenges caused by our changing climate and the increasing frequency and severity of natural disasters.

Key to the Climate Summit was Willis’ 1-in-100 Initiative, a drive by an alliance of public and private sector organizations to integrate natural disaster and climate risk into financial regulation globally.

1-in-100 Initiative
At the core of the Initiative is the 1-in-100 year solvency “stress test”, a similar concept to that developed in recent years by the insurance sector to assess its own ability to manage risk. The test evaluates the maximum probable annual financial loss that an organization, city, or region, could expect once in a hundred years, in order to enable them to manage their risk in a more informed and effective way.

By applying a 1 in 100 year solvency ‘stress test’ to current assets and current climate conditions, organizations can understand their risk and manage it in an economically rational way. The UN Secretary General’s Office and regulatory authorities will work together to apply these principles within the global financial system by 2020.
Assets and Investments
According to the OECD, in 2012, institutional investors held over $83 trillion in assets. This includes pension funds, endowments, foundations, investment funds and insurers. And yet only a small part is placed in climate resilient investments or infrastructure projects. This is partly due to the complexities of climate risk analysis as well as the lack of financial incentives and rewards to investors. The 1-in-100 initiative will change this.

Leaders from the global insurance industry, which manages a third of global assets under management, have already committed to creating a Climate Risk Investment Framework that would become accountable under the UN Hyogo Framework for Action and would see a doubling of climate-smart investments by the end of next year and a ten-fold increase by 2020. The investment framework will overlay smart capital disciplines across the full spectrum of the industry’s asset management classes to better manage climate risk and build resilience to disasters.

In a joint action statement, after the Climate Summit the United Nations outlined the commitments made by the organizations involved in the 1-in-100 Initiative, including:

- Liaising with regulatory authorities and stakeholders to determine how the Initiative could be implemented by 2020.
- Establishing a Resilience Modelling and Mapping Forum to coordinate research programs and provide open modelling and mapping platforms. This is key to providing organizations with the data needed to evaluate their exposure to natural disaster risk.
- Coordinate at least $100 million annual investment into public science research by the global insurance industry from 2016 onwards.

Transforming Asset Management
The 1-in-100 Initiative aims to change our attitude towards climate change and it will also transform asset management and investment. Asset managers will begin to understand and manage climate risk within their portfolios. They will be able to integrate climate risk and resilience into investment decisions. They will be rewarded if they want to support the financial resilience of communities through climate smart investments.

Working together, the UN, the insurance industry, the financial sector, regulators, rating agencies and the wider business community will develop adoption of these standards. The rewards for integrating natural hazard risk into financial investments and decision making are huge; the protection of millions of lives and the saving of billions of dollars.

For further information please contact Olivia Gray (olivia.gray@willis.com); Chief Operating Officer, Capital, Science & Policy Practice, Willis.

November 2014
Are You Ready for (SEC Enforcement) Action?

With the amount of new resources and cooperative tools the SEC is openly devoted to pursuing bad actors in the asset management arena. The agency has declared that no infraction is too small to pursue and punish:

“Minor violations that are overlooked or ignored can and will lead to bigger ones, and, perhaps more importantly, foster a culture where laws are increasingly treated as toothless guidelines.” (Mary Jo White, Chairperson, SEC, 10/9/2013)

While compliance preparation has focused on policies and procedures to ensure investigations DO NOT happen, asset managers should also consider how to prepare and respond to an enforcement action. The failure to manage the enforcement risk associated with an investigation can lead to higher costs, loss of assets, employees and clients as well as damage to reputation.

Under the stewardship of the current chair, Mary Jo White, the SEC’s Division of Enforcement has added staff to nearly every major city in the U.S. Specialized units have been created to focus specifically on asset managers, to investigate and prosecute violations of the federal securities laws of 1933, 1934, and 1940. As the scope of these statutes is so immense, the SEC can investigate a broad array of conduct and virtually anyone. Much of the recent focus on asset managers has been driven by public and political pressure following high-profile cases such as the Madoff investment scandal.

2013 SEC Enforcement Actions

Of the close to 700 enforcement actions brought by the SEC in 2013, nearly 40% were against investment advisers/investment companies and broker dealers. Insider trading, driven by media attention, has represented less than 10% of the total SEC enforcement actions over the last 10 years. Investor complaints and whistle blower bounty programs are helping drive the continued focus on asset managers and as long as the negative media portrayal of the “bad actors” on Wall Street continues, most industry experts believe that enforcement actions will continue to trend upward.
Investment Adviser Enforcement Priorities for 2014/15

What are the hot topics? The SEC remains concentrated on:

- Allocation of Advisory Expenses
- Cross Trades
- Policies and Procedures
- Conflict of Interest
- Insider Trading

Additionally, the SEC is focused on individuals at C-suite level, not just the entities. Recently, the SEC has adopted a much tougher stance, requiring the targeted senior individuals to admit to guilt as part of any settlement. Many experts believe that requiring the admission of wrongdoing will result in more individuals taking their chances at trials.

Responding and Managing an SEC Investigation

In the unfortunate event that an asset manager is the subject of an investigation, there are several steps that should be immediately considered. First and foremost, if an asset manager receives a notice of Enforcement from the SEC, engage and involve experienced external legal counsel who can provide independent advice and guidance on how to manage the process. Secondly, the asset manager should notify its D&O insurance broker. Most D&O policies contain strict notification requirements and failure to promptly notify the insurer can result in the denial of the claim. Insurance companies will probably want to be involved in the process from receiving regular updates to approving outside legal counsel.

Cooperation and proactive discussions with the SEC investigators to understand the theory of the case and their level of interest in pursuing a formal action could pre-empt the Wells process. Although rare, a high level of co-operation might limit the scope of the investigation or result in it being discontinued. Additionally, compliance with the Wells Order is paramount to setting the proper tone. One cannot underscore the importance of document preservation, both hard copy and electronic. This policy should be firmly cascaded to all employees; the SEC will not look favourably upon individuals who destroy emails or documents and deviation could lead to an expansion of the SEC enforcement action. Staff should also exercise care not to create unnecessary documentation and correspondence about the case and investigation.

Asset managers should consider whether the matter warrants an independent, internal investigation. This could be performed by the firm itself or by an independent third party, such as a law firm, accountancy or a compliance boutique. An independent internal investigation might help determine the firm's overall defense strategy and help the firm assess the impact of any potentially public statements relating to the SEC investigation, which the SEC might subsequently assert were false. Remember, SEC investigations, while civil, can create a road map for class action litigants and investor lawsuits.

Insurance Considerations

As has been stated, the asset manager should contact its D&O insurance broker immediately for advice about policy notification requirements. Clearly, the stakes for asset managers, their senior managers and C-Suite executives have been raised significantly by the SEC's investigations and the need has increased for enhanced protections under the companies D&O insurance policies. Not only do senior managers and executives have to maintain a robust insurance program, they must carry appropriate limits relative to the risks stated above. Over the last couple of years, several enforcements actions have led to 8 figure defense bills, prior to any settlement.

Senior managers and the C-suite must also understand the implications of admitting guilt and its impact on future civil suits. The admission of guilt may negate future insurance coverage for collateral claims. An admission of guilt might also prompt investor litigation or class action lawsuits. An annual review of policies is mandatory to keep up to date of any changes in coverage's and standards.

Compliance Paradigm Shift

What does all this mean for asset managers today? The SEC is taking a more robust approach to the asset management industry and has already jailed some high profile C-suite executives. It is no longer sufficient to adopt the traditional compliance approach of preparedness through policies, processes, routine examinations and audits. The paradigm has shifted and asset managers have to adopt a more pro-active and institutional approach to the risk of investigation and must be ready to deal and respond to the SEC. The benefit of planning in advance and testing to ensure the length and impact of an investigation is minimized may protect you and your firm from the unforeseen implications of an enforcement action.

For further information on SEC enforcement action and its impact upon Asset Managers, please contact Nicole Segal.

November 2014
Numerous studies have concluded that corporate reputation is one of a business’ most important strategic assets, with research citing the contribution of intangibles to a company’s balance sheet (of which reputation is the largest) at around 70% of market value. Anecdotal evidence appears to support this claim: Libor rigging and environmental lawsuits have dented both reputation and share price of Financial Institutions and Energy Companies in recent years.

The advance in processing power together with new techniques to analyse publically available content have combined to enable, for the first time, rigorous and data driven understanding of reputation. The net effect of these developments is the realisation of a breakthrough in reputation risk management which is already delivering valuable new insights.

**Reputation – a new paradigm**

Reputation risk is a daily challenge for most businesses, especially given the greater inter-connectivity of stakeholders afforded by technology such as twitter, facebook, blogs and other social media. This has resulted in a significant paradigm shift for companies where the old methods of “massaging” reputation through content dissemination, press releases and “managing expectations” are no longer fit for purpose.

A company’s stakeholders - customers, investors, suppliers, financial analysts and regulators - form opinions, interact with each other and generate positive or negative views of the organisation from the mass of information available to them. Their expectations are often influenced by what competitors are doing, products they are selling or salaries they are paying and they adjust their behaviours in response to such competitor interactions and messages.
Similarly, businesses are used to facing criticism from different stakeholders or interest groups, but they may not have fully appreciated the extent to which this has the potential to be amplified, to grow and thereby influence others into changing their view or relationship with the company. Although many senior risk managers acknowledge that damage to their reputation is one of the most significant threats to their company, very few organisations have been able to successfully establish processes to effectively quantify or monitor reputation or respond to emerging reputational risks.

**Changing perceptions and measuring sentiment**

Reputation risk is not confined to high-profile, sensational incidents with global impact. The different response of the insurance and banking sectors in the UK to the issue of premium rate phone lines demonstrates how positive engagement in one sector affects and impacts another.

In 2013 the use of premium rate customer phone lines by the financial and insurance sector was the target of high-profile campaigns from consumer groups. By November banks had committed to end their use. This was deemed a victory for consumers and resulted in the tapering off of negative sentiment on this issue towards the banks by April 2014.

In contrast, the insurance sector remained relatively unmoved on the use of premium rate phone lines. It faced increasingly damaging coverage and a comparison with the banking sector seemed to compound negative sentiment. This came to a head after February 2014 when the worst flooding in recent years produced significant criticism towards the insurance sector over the cost of making a claim. Victims of a natural catastrophe were perceived as being further victimized by costly premium rate customer phone lines.

The impact of this issue on the reputation of each sector is revealed by new metrics made available through detailed analysis of all media content, as illustrated below.

**Average volume of premium phone lines content for insurers and banks split by sentiment (Nov 2013-Apr 2014)**

![Graph showing average volume of premium phone lines content for insurers and banks]

As the data shows, the customer sentiment towards the insurance sector remained negative between November 2013 to April 2014. In contrast, the banks' proactive management of the issue resulted in some positive sentiment over the same period. This exemplifies the movement from risk mitigation to opportunity maximisation.

**Opportunity Maximisation**

The “reputational return” for banks as a result of moving early on the issue of premium rate phone lines came not only in the form of mitigation of negative sentiment (see the figure above) but also from avoiding a more targeted campaign by industry critics and consumer groups, following the flooding, towards companies yet to switch to low-cost numbers. These companies were increasingly targeted in contrast to banks that had pro-actively managed the reputational risk by ending the use of premium rate phone lines.

The banking sector's response is a prime example of a sector maximising its opportunity by enhancing its reputation relative to its peers. Reputational performance is a relative phenomenon based on a relative narrative. Active risk management of an issue, like premium rate phone line usage, can be proactively undertaken with the aim of maximising reputational opportunity over competitors and accruing a reputational return.

**Reputational Analysis through Big Data**

The metrics displayed above are only part of the new suite of analytical tools available to help identify risk to reputation. These metrics are derived from big data and analysis of key drivers of reputation – such as employee engagement or local community relations – which now makes it possible to quantify stakeholder sentiment with more accuracy than ever before.

With many still recovering from the financial crisis and the press filled with stories of financial scandals, there is a strong basis for the claim that reputation management matters now more than ever. The paradigm shift from compliance and mitigation to opportunity maximisation is already delivering a reputational return to some companies and industries over others – the case of premium phone lines offers a learning point in this respect.

---

1. Rayner, “Understanding Reputation Risk and Its Importance”, p.1
2. Economist Intelligence Unit, “Reputation Risk of Risks”, p.6
3. *alva* data showing average volume (total number of articles, tweets, broadcasts etc) of premium phone lines content per company for insurers vs banks split by proportion of negative, neutral and positive sentiment.
4. *alva* data showing average volume (total number of articles, tweets, broadcasts etc) of premium phone lines content per company for insurers vs banks split by proportion of negative, neutral and positive sentiment.
5. Two stages of Ainsbury and Grayson’s corporate responsibility maturity model.

November 2014
Recent events remind us once again of the potential impact a localized event, issue or regulatory development can have on financial institutions which operate with a global footprint.

Financial institutions are frequently the first to open offices in emerging economies, bringing much needed investment and employment. Recent events remind us that the relative political, social or regulatory maturity between the home and host regions can create certain risks and challenges.

Opening the Door
The region’s economic and regulatory environment will often determine financial expansion. Financial institutions have frequently shown their willingness to move to different jurisdictions to take advantage of favorable conditions. Myanmar partially opened the door earlier this year when the Myanmar Foreign Bank Licensing Committee recently granted preliminary approval to 9 foreign banks to operate. The preliminary approval will last for 12 months. Assuming the bank complies with all relevant requirements for the 12 month period, the Central Bank will grant the relevant bank a full license to operate in Myanmar. This should bring investment to the expanding economy, although US OFAC restrictions still bite and restrict working with certain individuals and entities.

Regulatory developments not only in the host economy but in the home economy are increasing the need for such operations to be treated as more than a “little dot” on the ever expanding global footprint. The proposed expansion of the directors disqualification regime in the UK which will introduce “broader and more generic” provisions in relation
to the matters determining the unfitness of a director imply that it would be possible to take a director’s overseas misconduct into account in disqualification proceedings in the UK. This will probably cause concern to directors of UK incorporated companies with global operations, as it would mean that the different risks facing directors overseas are now transported back into the UK.

As a result, organizations have to pay more and more attention to their operations in every corner of the world.

**Local Event, Global Impact**

The recent civil disobedience in Hong Kong and the Ebola outbreak remind us how events in one corner of the world can, and increasingly will, have ramifications for the rest of the world. Financial institutions, which might be used to relative stability in their home and host country, need to manage and respond to these risks.

Such events can and have led to the activation of business continuity plans (BCP) for many businesses. At a minimum, organisations must examine and re-evaluate their BCP-readiness. It might be interesting to consider how closely aligned these plans are between local subsidiaries and those of their parent companies. What were their BCP trigger points and how were they able to manage and monitor the activities of their third party vendors during the BCP period? How were these disclosed or reported to their parent companies as part of their overall risk management?

**One Step Removed**

This becomes even more complex when organizations not only have to consider, assess and quantify the risks of their own operations and activities, but to do so for the activities of third parties on whose services they rely. Financial institutions are frequently reminded that while they may outsource a critical function, they cannot outsource their responsibility for that function. This issue has been of particular concern for asset managers with the UK regulator placing significant weight on this issue. The SEC has also looked at this issue from a cybersecurity perspective.

Both these issues were at play in December 2013 when a Singapore based bank announced that over 600 private client bank statements had been stolen from a third party server. The bank's own servers and IT systems do not appear to have been breached. Following the incident, some firms are considering bringing certain activities back in-house. Outsourcing remains on ongoing issue; in September, the Singapore Monetary Authority released a consultation paper on Guidelines on Outsourcing and Notice on Outsourcing. The Guidelines and Notice set out minimum standards for outsourcing arrangements and are designed to raise risk management practices.

The question for financial institutions with a global footprint is how robustly are they assessing their operations in terms of these aspects, especially for their operations in emerging economies or in territories with vastly different regulatory environment compared to their U.S. or U.K. headquarters? This also begs another question for U.S.-listed non-financial institutions with financial institution subsidiaries overseas. Are they subjecting these operations to close scrutiny and ensuring that their outsourced functions are vetted with a fine tooth comb?

The flip side of the coin is probably true as well. Are risk managers of overseas subsidiaries of U.S.-listed companies fully aware, trained and compliant with the disclosure requirements imposed on their parent companies? A local risk culture that embodies such awareness and compliance would reduce an organization’s overall risk exposure.

It may well prove to be a useful exercise to reaffirm that, despite ever expanding overseas operations that are sometimes out of sight, they are never really out of mind.

---

1. *Directors’ liability, D&O: Blurring the lines, A Survey conducted by Allen & Overy and Willis, September 2014*

November 2014
FINANCIAL INSTITUTIONS GROUP
GLOBAL FIG CONTACT DETAILS

GLOBAL LEADERS

Mary O’Connor
Global Head of Financial Institutions
+44 (0)20 3124 8991
mary.oconnor@willis.com

John Brosnan
Global Head of Sales
+44 (0)20 3124 6427
john.brosnan@willis.com

Jagdev Kenth
Director of Risk & Regulatory Strategy
+44 (0)20 3124 8560
jagdev.kenth@willis.com

REGIONAL LEADERS

Richard Magrann-Wells
US Co-Regional Leader
+1 212 915 8357
richard.magrann-wells@willis.com

Zakia Campbell
US Co-Regional Leader
+1 212 915 8548
zakia.campbell@willis.com

Natalia Char
Latin America Regional Leader
+57 (1) 606 7575
natalia.char@willis.com

Tony Mitchell
Asia Regional Leader
+65 6591 8055
tonym@willis.com
FINANCIAL INSTITUTIONS GROUP

GLOBAL FIG CONTACT DETAILS

REGIONAL LEADERS

Jonathan Bush
UK Regional Leader
+44 (0)20 3193 9495
jonathan.bush@willis.com

Silvi Wompa
Western Europe Regional Leader
+4 684 638 926
silvi.wompa@willis.com

George Harding
Australasia Regional Leader
+61 2 9285 4091
hardingg@willis.com

Alexander Van Kuffeler
CEMEA Regional Leader
+44 (0)20 7558 9281
avkuffeler@willis.com
This publication offers a general overview of its subject matter. It does not necessarily address every aspect of its subject or every product available in the market. It is not intended to be, and should not be, used to replace specific advice relating to individual situations and we do not offer, and this should not be seen as, legal, accounting or tax advice. If you intend to take any action or make any decision on the basis of the content of this publication you should first seek specific advice from an appropriate professional. Some of the information in this publication may be compiled from third party sources we consider to be reliable, however we do not guarantee and are not responsible for the accuracy of such. The information given in this publication is believed to be accurate at the date of publication shown at the top of this document. This information may have subsequently changed or have been superseded, and should not be relied upon to be accurate or suitable after this date. The views expressed are not necessarily those of the Willis Group. Copyright Willis Limited 2014. All rights reserved.