

FS Insights

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Key Challenges Facing Financial Services in 2013

Basel III ... Dodd-Frank ... twin peaks model ... LIBOR manipulation ... data security ... mortgage reform ... risk management. Similar to 2012, these and other issues continue to evolve and very likely remain on the agendas of financial institutions as priorities to address in 2013. The global financial crisis continues to ebb, but these organizations are experiencing new waves of concern as they deal with a dynamic market and demanding regulatory landscape while maintaining or enhancing profitability and competitive positioning.

With this context, we offer these insights into some of the challenges financial institutions face in 2013.

Evolving and Uncertain Regulatory Environment

A dynamic, and often murky, regulatory environment arguably remains the top challenge for financial services institutions in 2013 (though there are a number of others, as we explore later). New and upcoming regulations in the European Union (EU), United Kingdom and United States, not to mention other jurisdictions, are sure to have a significant effect on financial services organizations, as are pronouncements from the Basel Committee on Banking Supervision. For multinational institutions, there almost certainly will be confusion and lack of clarity with regard to different, and perhaps competing, compliance requirements that they will need to dissect carefully.

Global View: Basel III Postponed, Liquidity Coverage Ratio Revised – In early January 2013, as many were expecting, the Basel Committee postponed the worldwide deadline for adopting the Basel III capital requirements.¹ (Of note, the European Union and United States, among many other jurisdictions, had already elected independently to postpone adoption of these requirements.) The Committee also approved a significantly revised version of the liquidity coverage ratio (LCR) requirements originally proposed in December 2010.²

The good news is that financial services companies now have more time to prepare to comply with the LCR standards.

However, with the many other financial regulations coming in these jurisdictions (including a number of new regulations for U.S. financial services organizations, as discussed further below), the delay likely will offer precious little reprieve for these companies. The coming year will still require them to devote significant time and effort toward establishing long-term profitability and liquidity/solvency given the capital requirements that will phase in beginning in 2015. They will need to implement a broad range of processes and procedures to ensure they have appropriate and compliant data management and reporting in place, along with supporting infrastructure and capital processes to execute the capital plan and report according to the pending Basel III requirements.

U.S. View: Dodd-Frank, Mortgage Reform and Election Impact – More than two years after the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), there remains a high level of uncertainty and lack of clarity regarding new and upcoming regulations. Many details still need to be formalized to determine how the Act's various provisions ultimately will affect the financial services industry.

As of October 2012, of the 400 total required rulemakings and other actions imposed by the DFA, 148 (37 percent) had been finalized (including 20 final agency actions not in the form of rulemaking), while 117 (29 percent) have yet to be proposed.³ Also of note, 117 rulemakings are still to come,⁴ which is further contributing to the air of uncertainty within financial institutions operating in the United States.

Many of the new regulations will be coming from the DFA-authorized Consumer Financial Protection Bureau (CFPB), which is changing the compliance landscape for all institutions that fall under its jurisdiction. The CFPB supervises large banks, thrifts and credit unions (those with over US\$10 billion in assets); non-bank institutions of all sizes that offer residential mortgages, private education loans and payday loans; and non-bank "larger participants" in certain financial markets, such as credit reporting and debt collectors. A large number of these companies have historically known only limited regulatory interaction and now find themselves under

¹ "Regulators Push Back Basel III Deadline," *FinCAD Derivatives News*, January 9, 2013: www.derivative-news.fincad.com/derivatives-regulations/regulators-push-back-basel-iii-deadline-5-2906/.

² "Liquidity Coverage Ratio: New Basel Measurement Published," *Morrison-Foerster News Bulletin*, January 10, 2013: www.mofo.com/files/Uploads/Images/130110-Liquidity-Coverage-Ratio.pdf.

³ "Dodd-Frank Implementation Status as of October 1, 2012," Morrison & Foerster LLP: www.mofo.com/resources/regulatory-reform/#DoddFrank.

⁴ *Ibid.*

the umbrella of a more rigorous regulator. For all institutions within the scope of the CFPB, expectations are increasing, particularly in the areas of monitoring and testing of processes, oversight of vendor compliance and internal audit. Throughout the year, organizations will need to review the strength of their internal audit and internal controls functions to protect themselves from the CFPB's new as well as upcoming regulations.

In early January 2013, the CFPB formally enacted a series of new regulations for home loan lending that will have a significant impact on mortgage lenders. Among the new requirements, qualified mortgages may not:⁵

- Offer interest-only payments or carry terms longer than 30 years.
- Generally carry fees and points in excess of 3 percent of the loan.
- Be approved for borrowers who will spend more than 43 percent of their income on debt payments.

In addition, potential borrowers will need to supply financial information and lenders will need to verify it.

These new regulations, which go into effect next year, will be top-of-mind in 2013 for U.S. financial services institutions in the mortgage industry. There are significant implications for these organizations and the industry, in general. For example, virtually every mortgage lender will have to retool its lending standards this year to comply with the CFPB's requirements in 2014, which almost certainly will require significant time, effort and resources.

The new regulations also could serve as a catalyst for some financial institutions to exit the home mortgage business altogether, further narrowing available choices and services for consumers.

Also of note, 2012 saw a sharp increase in enforcement activity by the CFPB, as well as by prudential banking regulators relating to fair lending and unfair or deceptive acts, which was expanded by the DFA to unfair, deceptive or abusive acts and practices (UDAAPs), particularly relating to marketing practices and product terms and conditions. UDAAPs are a potential risk in virtually every practice associated with offering and servicing consumer financial products and services.

As 2013 unfolds, financial institutions will need to continue enhancing employee awareness and evaluating relevant risks internally. They must be proactive in evaluating and strengthening their consumer compliance management programs in light of the guidance provided by and examination procedures utilized by both their prudential regulators and the CFPB. With regard to UDAAPs, financial institutions will need to demonstrate awareness of and efforts to identify and remediate these risks, from new product development

(and related terms, conditions and disclosures) and identification of high-risk areas to employee incentive compensation arrangements and how new regulatory guidance affects their UDAAP-related risks.⁶

More broadly in the United States, political developments already are cascading down from the recent national elections that may have a significant effect on financial services companies and their regulatory compliance frameworks and functions. Key changes in the political spectrum include, but certainly are not limited to, new members of Congress who have been proponents of higher consumer protection standards, as well as a widely anticipated new Secretary of the Treasury to replace Timothy Geithner, who has indicated plans to step down at the onset of President Obama's second term. (At the time this newsletter was published, the president had nominated Jack Lew, his current chief of staff, to be the new Treasury Secretary.)

EU and U.K. View: New Regulatory Directives and “Twin Peaks” – There are various regulatory bodies and regulations influencing the regulatory landscape throughout Europe and the United Kingdom, including numerous EU directives. The EU directives have been focused on topics similar to the U.S. Dodd-Frank legislation, including mortgages, liquidity, stress testing, recovery and resolution plans, short selling, the European Market Infrastructure Regulation (EMIR), and the Unfair Commercial Practices Directive (UCPD). Additionally, Europe is experiencing regulatory directives in transparency, electronic money regulations, remuneration code and CRD IV harmonized reporting.

Another EU directive, Solvency II, also is expected to affect the regulatory landscape significantly. However, there currently is a lack of consensus among regulators with regard to an implementation timetable.

Stemming from criticism of the performance of the U.K. Financial Services Authority (FSA) during the financial crisis, legislation was introduced in the United Kingdom to separate prudential supervision of banking, insurance and the larger broker-dealer institutions, as well as central clearing houses from market and conduct supervision – so-called “twin peaks.” This bill received Royal Assent in December 2012 and will come into force beginning April 2013.⁷ To prepare, the FSA has been operating internally with a twin peaks model. The U.K. administration has created two new regulators, the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), and is bringing about supervisory frameworks and management structures for these regulators and allocating financial institutions to their new regulators. It is expected these regulators will share information and cooperate with each other despite separate agendas.

⁵ “New mortgage rule aims to protect borrowers,” by Julie Schmit, *USA Today*, January 10, 2013: www.usatoday.com/story/money/business/2013/01/09/consumer-financial-protection-mortgage/1821329/.

⁶ For additional information, read Protiviti's Point-of-View papers, “Unfair, Deceptive (and now) Abusive Acts or Practices – New Requirements and Heightened Scrutiny” and “The CFPB is Coming – Are You Prepared?”, available at www.protiviti.com.

⁷ The press release by HM Treasury and a summary of the changes introduced by the Act can be found at www.hm-treasury.gov.uk/press_126_12.htm.

Also, the FSA published its finalized Mortgage Market Review (MMR) requirements in October 2012, the aims of which are broadly to create a sustainable and flexible mortgage market for the benefit of participants, including consumers.⁸ Although the new rules do not take effect until April 2014, the FSA has put firms on notice that it expects lenders to act fairly with customers who do not meet current tightened lending criteria.

Limited Regulatory Coordination Creating Confusion – As suggested in a recent *Financial Times* article, there seem to be some mixed messages, at least in the media, about the extent to which regulators are coordinating globally.⁹ The article described a letter to the paper from Federal Deposit Insurance Corporation (FDIC) Chairman Martin Gruenberg and Bank of England Deputy Governor Paul Tucker regarding a joint effort dealing with failing cross-border institutions. The article went on to discuss the rise of protectionism and the potential requirements for foreign subsidiaries to hold capital in the country in which they are operating.

While every new pronouncement or regulation, whether of a global nature or specifically in the EU, United Kingdom or United States, must be reviewed and addressed with exactness, the limited coordination of these initiatives creates a substantial challenge for financial institutions. These companies must work on coordinating their regulatory compliance efforts within their organizations to ensure a concerted effort dealing with the multiplicity of jurisdictions, regulations and regulators, including the DFA's creation of new regulators like the CFPB.

As a result of this dynamic regulatory environment, there continues to be a high level of uncertainty in the industry. Without a clear understanding of the long-term regulatory landscape, financial institutions will continue to find it difficult in 2013 to plan and innovate new products and services (as discussed further below).

Continued Focus on Risk Management

Given this dynamic and uncertain regulatory environment, financial institutions will be focused throughout 2013 on continuing to ensure their risk management functions and processes keep pace with changes and planning for compliance with upcoming regulations, especially in light of increasing expectations of regulators. Organizations will need to be sure they have robust risk frameworks and clearly defined risk appetites, responsibilities, tolerances and reporting to anchor decision-making. Risk appetite concepts will increasingly come under pressure to move beyond conceptual frameworks and paper to the “shop floor.” Evidence of risk appetite understanding and active decision management within the

appetite are being looked at as “real” examples that are applied in daily institutional practice. Regulators increasingly are looking for tangible “proof” that appetites are adhered to and want an institution to be able to articulate clearly and point to escalation protocols and mechanisms designed to enforce the stated appetites.

Furthermore, risk management infrastructure will need to have processes and capacity designed to execute decision trees based on real-time risk reporting. Management at all levels will be seeking more of this information to make informed decisions and recommendations to executive management and the board and execute on the broader risk strategy. Importantly, risk reporting is expected to be subject to continued refinement and focus. Too often, risk reporting is characterized by an abundance of data and information, but a comparative lack of insight and clarity. Financial institutions continue to be challenged to provide risk reporting that can answer these simple questions effectively and efficiently: “Is the organization riskier today than yesterday, why and by how much?”

Financial institutions must ensure their control infrastructures, processes and reporting within each area are evaluated and proven to work under current environments – this will increase confidence that they will function properly under more stressed conditions. Data quality will continue to be a key focal point, as well. Management, boards, risk management and internal audit departments all will play pivotal roles in meeting the increasing expectations of regulators as their institutions seek to build stronger and more stable risk management environments.

Expansion of Products and Services

With regard to products and services, two areas that financial institutions are sure to focus on in 2013 are innovation and social media.

Innovation, which has long been a cornerstone for the financial services industry to build revenue and profits, will be a growing challenge this year. New and emerging regulations in multiple jurisdictions are beginning to squeeze profit-making and revenue-generating opportunities of products and services upon which these companies have relied historically. At the very least, the ability to innovate is becoming more difficult and complex. At the same time, in what could be termed a “perfect storm,” it will be increasingly complicated to develop and introduce new products and services given the aforementioned regulations, as well as the growing number of regulatory bodies overseeing the industry.

Without question, one area with significant potential for innovation and growth is social media. A recent issue of Protiviti's *The Bulletin* explored the reasons for and challenges of using social media for business, and also highlighted significant trends supporting customer interaction and

⁸ The FSA policy statement on MMR and its published rules can be found at www.fsa.gov.uk/library/policy/policy/2012/12-16.shtml.

⁹ “U.S. and U.K. Unveil Failing Banks Plan,” by Brooke Masters and Chris Giles, *Financial Times*, December 10, 2012: www.ft.com/intl/cms/s/0/e1f27d04-41fc-11e2-bb3a-00144feabdc0.html#axz2FXcDZTWe.

customer engagement.¹⁰ Social media provides financial institutions with a customer interaction channel that is growing in usage, has the potential to engage customers in individualized ways, and could deliver higher ROIs. As a business, the institution must evaluate each channel from a cost-effectiveness and risk management perspective based on its ability and desire to provide services through the channel. As the proliferation of social media in financial services continues to grow in 2013, institutions will need to consider a variety of risks, including each channel's availability, reliability, efficiency, effectiveness, compliance, confidentiality and integrity. Management and boards must understand how they are reaching their customers. If their strategy is to strive for exceptional customer service, they must exemplify this behavior.

To this end, a recent survey of more than 3,000 consumers helped to identify what makes social media effective. The survey results indicate that customers who engage with companies over social media spend 20 to 40 percent more money with those companies than do other customers.¹¹ Each engagement with the customer allows the institution an opportunity to increase the customer's perceived value of the service and thereby, the potential to increase customer loyalty.

By focusing on interacting with customers on their terms and offering them individualized choices in how to handle their financial services engagement, whether through social media, mobile banking, more interactive branch staff or a yet-to-be-developed technology, financial institutions will be able to foster a customer-oriented culture and deepen relationships in the coming year.

Expense Management and Restructuring

Many banks in 2013 will continue to retrench on expenses given revenue pressures resulting from the low interest rate environment and the curtailment of certain fee income sources. Banks are examining business arrangements of all types, and are consolidating back- and middle-office functions to streamline processes and improve the customer experience. Certain larger banks are reorganizing many retail business units under the same leadership structure, bringing together under one roof auto loan, mortgage, credit card, and other consumer lending and deposit processes. This will create significant opportunity, as well as increased risk due to process flow changes, system enhancements and personnel changes that will be made over several years.

Security and Privacy Risks Keep Coming

Financial institutions are no strangers to privacy and security risks. Throughout 2013, they will be focused on a number

of especially critical areas. First, with regard to global and regional regulatory standards, these organizations will need to remain closely apprised of their myriad compliance requirements. For example, compliance with the EU Data Directive is becoming an increasingly complex task and critical concern for financial institutions operating in Europe as a result of the proliferation of mobile banking and e-commerce capabilities used to support their globe-trekking customers. And in the United States, the U.S. Securities and Exchange Commission (SEC) is calling upon (though not yet formally requiring) listed companies to report in public filings if they have experienced a security breach that had a "material" impact. It is possible other jurisdictions will implement such requirements, as well.

Another critical security and privacy challenge relates to social media. As noted earlier, financial institutions will be focusing more this year on social media channels to enhance customer service and potentially drive growth. Yet this initiative also raises significant risk-related questions for financial institutions. "How will various governing bodies in our highly regulated industry regulate our social media communication?" "How can we control what is being said and how it is said within social media networks?" These are global challenges for institutions that will require a clear understanding of regulatory requirements, as well as clear and detailed social media awareness, policies and procedures. The guidance from governing bodies like the Federal Financial Institutions Examination Council (FFIEC) is still maturing, leaving financial institutions in a tenuous position.

Cyberattacks will continue to pose a serious threat, as well. Distributed denial of service (DDoS) attacks are becoming increasingly sophisticated and, in some cases, are being attributed not only to global hacker groups, but also to certain foreign nations (e.g., Iran) intent on creating major disruptions in the United States and other countries. In many cases, these attacks begin with financial institutions before spreading to other organizations. Another major concern continues to be advanced persistent threats (APTs) – financial institutions will be investing significant time and resources to detecting and preventing these highly invasive and potentially catastrophic attacks.

As always, proper data classification and management will be a priority, as well. From a security perspective, a major concern in 2013 for financial institutions will be continuing to maintain proper control of corporate data and customer information even as it is stored and managed increasingly in the cloud and/or by third-party service providers (especially those in countries where issues persist related to proper security procedures for managing personally identifiable information). Such control must be in compliance with data and security and privacy regulations worldwide, including the EU Data Directive and numerous U.S. laws and requirements.

¹⁰ "Leveraging Social Business for Results: Moving Beyond Media," *The Bulletin*, Volume 4, Issue 12, 2012, Protiviti: www.protiviti.com/en-US/Documents/Newsletters/Bulletin/The-Bulletin-Vol-4-Issue-12-Social-Business-Protiviti.pdf.

¹¹ "Putting Social Media to Work," by Chris Barry, Rob Markey, Eric Almquist and Chris Brahm, *Bain Brief*, September 12, 2011: www.bain.com/publications/articles/putting-social-media-to-work.aspx.

Ensuring Data Integrity and Proper Data Management

With regard to data management, financial institutions in 2013 will not only be focused on security, but also on how to leverage this information most effectively. The combination of a dynamic environment and increased regulatory oversight continues to lead to a need for the availability of relevant, reliable and timely data to enable decision-making. The abundance of data available also means it is increasingly important to have good data quality and proper data management to offer insight to management and boards and enhance decision-making, rather than creating unhelpful informational noise. Institutions will continue to evaluate their data platforms and data integrity to the extent that they can leverage strong data governance, a common data language, data storage, real-time reporting, reporting infrastructure, and decision-making and risk management processes.

Additionally, financial institutions will continue to implement processes for prioritizing such information and presenting it in a way that adds value to the decision-making process and avoids inundating management and boards with an overabundance of data, much of which may be irrelevant. The use of a strong risk management framework, including risk appetite, risk frameworks, risk tolerances and risk decision-making processes, will help to ensure that data, if managed correctly, will assist management in executing its strategy.

Model Risk Management

Basel III and the EMIR, along with guidance issued for U.S. institutions by the Federal Reserve, FDIC and Office of the Comptroller of the Currency (OCC), are driving the need for significant changes in the model governance infrastructures of affected financial institutions. Among other needs, these requirements mandate that institutions hold more “risk-free capital,” the definition of which has narrowed. Additionally, this capital eventually will need to undergo periodic stress testing, which necessitates the need for various models per institution. Though the implementation of Basel III has been delayed (see the Evolving and Uncertain Regulatory Environment section), these issues will still monopolize the attention of affected financial institutions in 2013.

In the United States, regulatory bodies have been focusing on model risk, model governance and stress testing. Three notices of proposed rulemaking (NPR) in August 2012 focus on revising and replacing the regulatory capital framework, which also brings changes to, or completely new, measurement models.¹² The guidance is being reinforced with rigorous examinations and findings. Institutions of all sizes are struggling to comply with the new regulatory guidance.¹³

¹² Federal Register, Vol. 77, No.169, August 30, 2012: www.gpo.gov/fdsys/pkg/FR-2012-08-30/pdf/2012-17010.pdf.

¹³ For further details, read Protiviti’s Point-of-View papers on these three NPRs, available at www.protiviti.com.

Larger institutions, in general, already have varying degrees of model governance infrastructure, but typically have to upgrade the quality of their model documentation and model validation processes. Virtually all organizations will continue to struggle with data quality and availability. Large institutions may have model risk departments/functions but have resource needs in obtaining specialized skills and completing large model building or model validations in a timely manner. Small- and medium-sized banks are beginning to build their model risk infrastructure, often starting with a model risk oversight committee or equivalent, which consists of members of risk management, modelers and business owners, with internal audit frequently serving in a non-voting capacity. Most small- and medium-sized institutions typically have only one or two individuals in charge of model risk management, so there is great reliance on external resources in both building and validating models. Yet the accountability and responsibility for sound model risk management rests squarely on management and the board.

Even regulatory bodies are not immune to model governance issues. Just recently, the Office of Financial Research, another agency created by the DFA, issued a working paper noting that the models used by the regulators themselves to assess risk need to be fundamentally changed, and until that happens, they are likely to be useful during normal times but not when they matter the most.¹⁴ Any changes in these models will likely have a trickle-down influence on those employed by financial institutions.

Derivatives Trading Reform

New and updated regulations around derivatives trading within numerous jurisdictions will require financial institutions to design and implement significant business model, infrastructure, process and control changes throughout 2013. Examples of changes that have been introduced or are coming in 2013 include the following:

- For U.S. financial institutions and non-U.S. institutions operating in the United States, Title VII of the DFA requires greater transparency and regulatory oversight to swap trading by way of introducing a derivatives clearing organization (DCO) and the execution of swap trades via a swap execution facility (SEF). These changes will completely reshape the way derivatives are traded and settled. Derivatives no longer will be traded over the counter (OTC) between parties, but instead will be traded on exchanges overseen by the SEC and U.S. Commodity Futures Trading Commission (CFTC), and cleared through clearing houses.
- For financial institutions in Europe, the EU, through the EMIR, is imposing requirements on entities of all sizes, both EU and non-EU firms trading with EU firms, that enter into derivative contracts, including those outside

¹⁴ “Clouds Seen in Regulators’ Crystal Ball for Banks,” by Floyd Norris, *New York Times*, January 10, 2013: www.nytimes.com/2013/01/11/business/economy/models-for-financial-risk-are-still-seen-as-flawed.html?ref=business&_r=0.

of financial institutions. Entities with derivative contracts will be required to (1) report every derivative contract into a trade repository; (2) implement new risk management procedures, including operational processes and margining; and (3) clear through the central counterparty (CCP) those OTC derivatives subject to a mandatory clearing obligation. Additionally, the CCPs are caught by the amendments to risk management procedures introduced by the EMIR, including being able to offer improved client segregation and portability.

Just some of the many changes financial institutions will need to address in their derivatives trading functions include amending business processes to support the cleared OTC contract model, policies and procedures; significant IT modification to support the new market infrastructure; changing front-office behavior to support real-time reporting; developing due diligence and monitoring strategies; informing and training staff; and instituting proper measures for recordkeeping.

Balancing Incentive Compensation

Financial institutions in 2013 must ensure they align risk and compensation in their organizations. This will be a particular area of focus for U.S. institutions and non-U.S. institutions operating in the United States, as prudential banking regulators are expected to finalize rules to require organizations to take steps to align incentive compensation with balanced risk-taking and increased reporting requirements. These rules, once finalized, will effectively implement as mandatory the guidance that was issued a couple of years ago.¹⁵ (Of note, a 2011 Federal Reserve incentive compensation report noted that, while progress had been made, large banking

organizations still had work to do to improve their incentive compensation programs.)¹⁶

There may be slightly less of a focus on this area among European institutions given that the EU has had such requirements in place for a while, though some anecdotal evidence suggests that supervisors in these regions remain to be convinced that risk and compensation is aligned properly.

Given the heightened regulatory environment worldwide, financial institutions in 2013 likely will continue to evaluate their incentive compensation structures to ensure they are driving the desired behaviors from their employees. They also should implement robust risk management processes to ensure proper alignment of incentive compensation with both strategic objectives and company risk appetite, and to meet increasing demands for information and reporting. Institutions also should evaluate their incentive compensation in relation to their ability to attract and retain talent, and ensure they can remain competitive in the marketplace and reward and retain individuals with their valued qualities and risk-taking behaviors.

In Closing

While many of the coming year's challenges reflect similarly to those of 2012, their nature and effects continue to evolve as a result of new economic and regulatory developments. Institutions will need to remain nimble, flexible, and conscious of changes in the market and regulatory landscape. The actions and reactions of management and the board will be key indicators to employees as well as outside stakeholders of how the organization intends to address these challenges successfully over the long term.

¹⁵ Guidance on Sound Incentive Compensation Policies: "Agencies Seek Comment on Proposed Rule on Incentive Compensation," Board of Governors of the Federal Reserve System, March 30, 2011: www.federalreserve.gov/newsevents/press/bcreg/20110330a.htm.

¹⁶ *Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations*, Board of Governors of the Federal Reserve System, October 2011: www.federalreserve.gov/publications/other-reports/incentive-compensation-report-201110.htm.

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