ADVISEN Insight for Insurance Professionals

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Diversified Financial Services Risk Management Perspectives

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Industry Overview

Investment Banks and Securities Firms

Firms engaged in investment banking and securities trading serve as intermediaries between investors and issuers of securities and other investment products. These firms research, evaluate, underwrite, purchase, and sell securities and other investments for their clients and for their own account. The purpose of these businesses is to raise capital for companies issuing securities and obtain investment profits for those purchasing securities. There are also companies that manage assets and other investments on behalf of clients, and provide investment-related financial planning advice, either in conjunction with investment banking and brokerage services or as specialized boutique firms.

In addition to industry behemoths, there are many medium and small firms, including boutiques that specialize in a particular segment of the industry. These firms may specialize in investments related to specific types of businesses (e.g., telecommunications, biotechnology, and chemicals), specific kinds of transactions and investments (e.g., mergers and acquisitions, mutual funds, and government bonds), and specific customers (such as discount brokers specializing in financial planning and stock trades for middle income investors). Even among boutique firms and their larger brethren, the lines demarcating who does what often become blurred. If there is potential profit to be made, these firms will not hesitate to diversify their business mix or customer base.

There are also companies that have a stake in all of these sectors. Sometimes referred to as "multi-sector holdings," these companies, through multiple subsidiaries, operate at both extremes of the industry, serving multinationals and individuals. Whatever they call themselves, the reason for being of these firms is to make investment profits for, or preserve the assets of, their clients. Clients range from Fortune 500 corporations and governments to pension funds to individual investors.

Phoenix Rises From Ashes of Scandal

In the past three years, the investment banking industry has been rocked by a series of scandals of unprecedented severity. Bankers have been arrested and tried. Hundreds of millions of dollars in fines have been imposed on the industry. New rules have been drawn up setting out demarcation lines between analysts and investment bankers. Everywhere you look, the industry has been under attack.

Yet in the past year investment banking has been booming as never before. Those most closely caught up in the web of scandal in which the industry has become enmeshed have been making record profits. Far from being damaged by the scandals, investment banks appear to have successfully weathered the storm, and have even thrived.

Big investment banks have been both over and under analysts' earnings estimates, but common themes have emerged. Trading revenue in some businesses was down, and the summer's sluggish environment on Wall Street slowed the recent steady rise in profits. On the upside, industry heavy-hitters Bear Stearns Cos. Inc., The Goldman Sachs Group Inc., and Lehman Brothers Holdings Inc. beat analysts' third-quarter average estimates. Bear Stearns exceeded the Street's earnings-per-share estimate of $1.98 for the quarter by 11 cents. The firm's net income, however, slid almost 10% compared with last year's third-quarter profit. Lehman and Goldman reported earnings per share of $1.71 and $1.74, respectively.

Morgan Stanley, however, missed estimates by a wide margin, reporting earnings for the quarter of 76 cents a share. The company had been expected to earn 96 cents a share, according to a survey of analysts by Thomson Financial/First Call of Boston. Reduced trading revenue resulted in lower quarterly earnings, the company said. Compared with those of the same quarter last year, Morgan Stanley's profits were down 34%, with revenue falling 18%, and equity trading down 21%. Meanwhile, Morgan Stanley said, it had agreed to pay $19 million to settle New York Stock Exchange charges that it failed to meet prospectus delivery requirements and to settle claims against a former broker who allegedly stole $56 million from clients.

Profits Rise, Even If Ethics Don't

Despite all the biased research, late-trading, and market-timing scandals of the past year, culminating in record penalties of about $1.4 billion, investment banks are making record profits. The Securities Industry Association estimates that Wall Street firms will earn $22.5 billion in 2004, over three times what they made in 2003, and more even than the $21 billion they made in 2000. This year, according to consulting firm Mercer Oliver Wyman, the sector's return on equity will be around 20%, almost double last year's figure, and only slightly less than the peak of 24% in pre-scandal 2000, when the Internet and technology bubble had yet to burst.

And there is evidence that regulators apparently care a lot more about the mutual fund scandal than the investors they are trying to protect. Eighty-six percent of 744 fund investors said that the fund scandal had not changed their investments in any way, and 75% could not name even one firm involved in the scandal, according to a survey conducted in August 2004 by Boston-based Dalbar Inc. Although much has been made about the funds' market-timing and late-trading violations, half the investors surveyed did not know what market timing means, and 57% could not define late trading.

Research Becomes Hot Button

A recent survey of 37 independent research companies found that 95% of them reported being adversely affected by the growing reluctance of money management firms to use commission payments for independent research. The study was conducted by Investorside Research Association in Washington, DC, which represents the independent research industry. Investorside said the survey confirmed that there has been a “dramatic chill”' in the independent research industry because of uncertainty surrounding the Securities and Exchange Commission's study of the “soft dollar”' use of trading commissions to finance research. The study found that 54% of the responding firms had postponed hiring, and another 11% had reduced the size of their work forces, as a result of the decreased use of commission payments for research.

Seventy percent of the respondents said they would consider getting out of the independent-research business if soft dollars were banned altogether, which some critics of the securities industry have championed. In a September 3rd letter to SEC Chairman William H. Donaldson, Investorside officials said there is growing evidence that institutional investors, including mutual funds, are shifting away from using independent research in favor of Wall Street investment bank research. Institutional investors have gotten about 15% of their research from independents, which they typically pay for with commissions. But fund industry scandals have led many to question the use of commissions to pay for research. “Independent research represents the strength of our market system, and we should certainly avoid unnecessarily undermining it,” said SEC member Harvey Goldschmid. Under a settlement reached with the Wall Street investment banking industry, Wall Street firms are funding independent research that is to be distributed to clients.

Bad Eggs Send Industry Scrambling

The most significant and lasting influence on the investment banking and securities industry may be Enron, WorldCom, Tyco, and their many ripples and ramifications. The scandals touched not only those companies, but their bankers and investment bankers as well. Besides investigating the accounting abuses that led to the collapse of Enron and the restatements of financial results at WorldCom, regulators have been scrutinizing investment bankers' relationships with research analysts and commercial bankers. Self-regulatory organizations such as the National Association of Securities Dealers and the SEC have imposed new disclosure requirements on securities analysts and have tried to re-build the walls between them and investment bankers. These actions followed disclosure that some research may have been biased in favor of companies that the investment banking side of the firms had an interest in touting.

Scandal Timeline

No analysis of the financial services industry is complete without understanding the progression and effects of the scandals that have reshaped how business is conducted (dates are from late 2003 into 2004):[1]

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[1] “A Year Later, Assessing the Fund Landscape,” InvestmentNews, August 30, 2004.

September 3, 2003 - New York Attorney General Eliot L. Spitzer announces a probe into Secaucus, N.J.-based hedge fund Canary Capital Partners LLC, which settles for $40 million. He says Bank of America Corp. in Charlotte, N.C.; Bank One Corp. of Chicago; Janus Capital Group Inc. in Denver; and Strong Capital Management Inc. of Menomonee Falls, Wis., are under investigation.

September 30 - Mr. Spitzer and the Securities and Exchange Commission contact Alliance Capital Management LP in New York in connection with market timing.

October 22 - Federated Investors Inc. in Pittsburgh says improper trading occurred in its funds and that it was subpoenaed by Mr. Spitzer's office. The SEC also requests information.

October 28 - Putnam Investments LLC in Boston is the first company to be charged with securities fraud in the widening probe.

November 4 - The SEC and William F. Galvin, secretary of the commonwealth of Massachusetts, file civil complaints against seven former employees of Prudential Securities Inc. in New York, accusing them of market timing and late trading.

November 13 - Putnam says it will reform its business practices and reimburse clients to settle federal charges of improper trading.

November 20 - Pilgrim Baxter & Associates Ltd. in Wayne, Pa., is charged by the SEC and Mr. Spitzer with questionable trading activity.

December 2 - Mr. Spitzer, the SEC, and Colorado Attorney General Ken Salazar charge INVESCO Funds Group Inc., a Denver-based unit of London-based AMVESCAP PLC, and Raymond Cunningham, INVESCO's chief executive, with engaging in a ``massive mutual fund timing scheme.''

December 2 - Strong Capital says Richard S. Strong has resigned as chairman, chief executive, and chief investment officer of the company. The announcement comes on the heels of allegations that he engaged in market-timing trades of his own firm's funds.

December 8 - Sun Life Financial Inc. in Toronto says the SEC might bring an enforcement action against its subsidiary, MFS Investment Management of Boston, and Mr. Spitzer says he also is probing the company for possible market-timing activities.

December 18 - Alliance Capital agrees to pay $250 million in fines and cut its fees by 20%, or $350 million, over five years.

February 4, 2004 - Mr. Galvin charges Franklin Resources Inc. in San Mateo, Calif., with fraud for allowing a Las Vegas investor to market-time its funds in exchange for investments from which it earned fees.

February 5 - MFS settles with the SEC for $225 million and with Mr. Spitzer for $125 million. It also agrees to pay New Hampshire securities regulators $1 million to set up an investor education fund.

February 18 - Franklin Resources says the SEC may sue the company and its co-CEO, Gregory Johnson, over allegations of market timing.

February 24 - The SEC and Mr. Spitzer charge Boston-based Columbia Management Advisors Inc., a unit of FleetBoston Financial Corp., with allowing certain investors to market-time funds.

March 3 - RS Investments in San Francisco discloses that Mr. Spitzer and the SEC are probing possible market timing in one of its funds.

March 3 - Regulatory filings reveal that Mr. Galvin, Mr. Spitzer, and West Virginia Attorney General Darrell V. McGraw Jr. have asked Fred Alger Management Inc. in New York for information on market timing and late trading in its funds. No charges are brought, but it is revealed that in December, former Alger vice chairman James Connelly was sentenced to prison for tampering with evidence as part of a probe into whether the firm allowed late trading.

March 5 - MetLife Inc. in New York says regulators requested information from the company with regard to late trading and market timing of mutual funds and variable-insurance products.

March 15 - Bank of America and FleetBoston, which Bank of America is acquiring, agree to pay $675 million in fines, restitution, and a reduction in management fees to resolve charges that they allowed improper trading.

April 5 - Former Bank of America broker Theodore Sihpol is indicted on 40 counts of fraud, grand larceny, and falsifying business records for allegedly helping a hedge fund trade mutual funds illegally, court papers show.

April 8 - Putnam agrees to pay the SEC and Massachusetts regulators $110 million in fines and restitution to investors.

April 27 - Janus settles with the attorneys general in Colorado and New York, as well as with the SEC. It agrees to pay $225 million in restitution, fines, and fee concessions. Of that total, $50 million will be returned to fund holders, $50 million will go to pay fines, and $125 million will come in the form of lower fund expense ratios during the next five years.

May 6 - Regulators bring fraud charges against the mutual fund affiliates of Munich, Germany-based insurer Allianz AG.

May 11 - J. & W. Seligman & Co. Inc. in New York announces that it paid almost $2 million to three of its own mutual funds in a move related to the industrywide improper-trading scandal.

May 20 - Mr. Strong, other Strong executives and the firm agree to pay more than $140 million and reduce fund fees by about $35 million to settle state and federal charges of improper mutual fund trading. Regulators also banish Mr. Strong from the investment business.

June 1 - Three affiliates of Allianz say they have agreed to pay a $15 million fine to settle allegations of improper mutual fund trading with New Jersey Attorney General Peter Harvey. PA Distributors LLC of Stamford, Conn., and PEA Capital LLC in New York, without admitting or denying findings of improper fund trading, say they will reimburse the attorney general's office for costs of an investigation and will implement new policies and procedures to strengthen corporate governance.

June 21 - Pilgrim Baxter settles with the SEC and Mr. Spitzer. The firm agrees to pay $40 million to affected

investors and $50 million in civil penalties. In a separate agreement with Mr. Spitzer's office, Pilgrim Baxter agrees to reduce management fees over a five-year period, a reduction valued at $10 million. The settlement also requires the company to provide full cooperation to Mr. Spitzer's office in the continuing litigation against Gary L. Pilgrim and Harold J. Baxter, the former principals of the firm and founders of the PBHG Funds.

June 29 - The SEC says Bank One's Banc One Investment Advisors Corp. unit in Columbus, Ohio, will pay a $40 million civil penalty and repay $10 million in ill- gotten gains. In addition, the SEC says, Mark Beeson, One Group Mutual Funds' former chief executive, agrees to a $100,000 penalty and a two-year ban from the fund industry.

July 8 - Money manager Fremont Investment Advisors Inc. in San Francisco says at least one current employee and one former employee have received notice that they may face enforcement action over previously disclosed improper trading in the firm's mutual funds.

August 2 - The SEC says Franklin Advisers Inc. in San Mateo will pay $50 million to settle charges that it allowed improper, rapid trading of its funds' shares.

August 6 - Nationwide Financial Services Inc. in Columbus, Ohio, says that the SEC and Mr. Spitzer are conducting an investigation related to questionable trading in funds in the company's variable insurance products.

August 9 - Subsidiaries of Conseco Inc. of Carmel, Ind., and a successor company agree to pay $20 million in restitution and fines to the SEC and Mr. Spitzer, settling charges related to questionable trading in funds in the companies' variable insurance products.

August 19 - For the first time, NASD prohibits a regulated firm, National Securities Corp. in Seattle, from opening mutual fund accounts for new clients for 30 days, charging it with facilitating deceptive market-timing practices and failing to have an adequate supervisory system to prevent deceptive market timing and late trading.

August 25 - The SEC files fraud charges against brokerage firm JB Oxford Holdings Inc. in Beverly Hills, Calif., and its subsidiary National Clearing Corp. for improper mutual fund trading. The SEC says three NCC executives were also charged for allowing certain customers to engage in late trading and market timing in more than 600 mutual funds from June 2002 through September 2003.

Consumer Finance

Companies in the consumer finance industry consist principally of credit card companies, firms that specialize in home equity loans, and companies that finance the purchase of automobiles and other high-value durable goods. This industry is often grouped with the diversified financial services (investment-related banks, brokers, and management companies) and multi-sector holdings (companies involved in banking and other financial businesses) industries. Many of the companies in the consumer finance industry seek out a niche and develop specialized financing and marketing programs for that niche.

Interest Rates

Interest rates have a dramatic effect on the profitability of consumer finance companies because they impact the demand for credit, the cost of funds, and the potential for charge-offs. When rates are falling, the cost-of-borrowing is reduced, and in turn, demand for the industry's products and services increases. In addition, as interest rates fall, the cost of the funds that companies use to make loans falls and lending "spreads" widen, increasing industry profits. Consumers' monthly payments are lower, so the chances of default or bankruptcy are also lower.

In addition, low interest rates tend to spur economic growth, which in turn leads to job creation and job security, which results in higher credit quality, increased consumer confidence, and more borrowing. When interest rates go up, the economy usually sours, jobs are lost or the perception that they may be lost exists, so consumers are afraid to borrow and make major purchases. Those that are forced to borrow during such a period are usually in dire financial straits, and their delinquency rate may be high.

Credit Quality

Prior to making a loan, consumer finance companies painstakingly investigate applicants' creditworthiness. This is ordinarily a highly automated process, with many firms having proprietary credit scoring systems. Credit reports with detailed payment histories may also be ordered from independent credit rating agencies, such as Experian or Equifax. Other data, including employment history, income, collateral, and current debt load are also considered. This information is often reviewed by credit analysts with substantial experience in separating good credit risks from bad ones. This process attempts to quantify an individual's ability and willingness to repay a loan. As many personal and human characteristics and flaws enter into the equation, it is an inexact although very necessary science.

Lending Spreads

Consumer finance companies tend to have substantial profit margins due to wide spreads: the difference between interest rates paid to obtain money in capital markets and interest rates at which money is loaned out. Such spreads can range from 6% to 12%, which is considerably more than banks ordinarily charge. The flip side of this advantage is higher risk and more defaulted loans. Delinquency rates are usually in the 3% to 4% range for most consumer loans, and a bit higher for credit cards.[2] Companies hope that higher spreads permit them to make enough money to ease the pain from increased defaults.

Competitive Pressures

The competition in consumer finance is intense. As companies in this industry are in effect providing money (a commodity), purchasers will almost invariably choose the company with lowest prices (interest rates). Despite advertising efforts touting service and intangibles, the product is still viewed as a commodity by most current and

[2] "Diversified Financial Services," Standard & Poor's Industry Surveys, August 16, 2001.

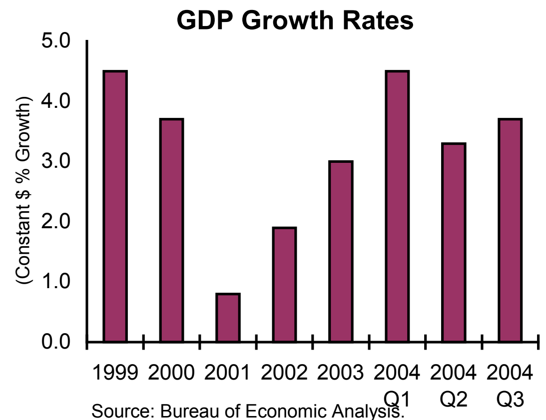
potential customers. Since financial products cannot be copyrighted or patented, competitors are quick to copy successful new products developed by other firms.

Passage of Gramm-Leach-Bliley may also add to competition, even though it has not appreciably done so yet, as banks and insurance companies may now enter financial services businesses easier than they could previously. Smaller financial services companies may face an especially difficult time competing with the monoliths formed through recent mergers and acquisitions.

Economic Indicators

The health of the diversified financial services industry depends on the financial health of the individuals and families it serves. When jobs are plentiful and the threat of unemployment is low, consumers feel confident about investing and making major purchases, and are more prone to use their credit cards and arrange long-term financing to buy cars, appliances, and other durables. Equally as important, they are able to make their monthly payments. Conversely, in a depressed economy, consumer optimism wanes, they fear or experience job loss, and they postpone or forgo major purchases. In addition, they may have difficulty paying for purchases already made, and in the worst cases may declare bankruptcy, making it unlikely that finance companies will be paid back in full or at all.

Corporate profits are once again growing, and that may produce more IPOs and other financial transactions requiring the services of investment banks. The recession of 2001 caused profits to fall to $767.1 billion, from $817.9 billion in 2000. But in 2002, corporate profits rebounded to $874.6 billion, and continued growing in 2003 to $1.0 trillion and reaching a seasonally adjusted annual rate of $1.1 trillion in the fourth quarter. By the second quarter of 2004, corporate profits rose to $1.2 trillion, continuing the strong trend upward.[3]

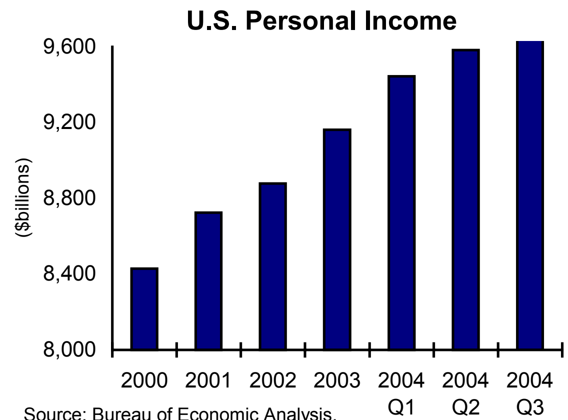


The financial services industry is highly dependent on the state of the overall economy. After the recession of 2001, which yielded 0.8% real gross domestic product (GDP) growth in the U.S., the economy remained sluggish in 2002 with 1.9% GDP growth. However, the economy picked up in 2003 with 3.0% GDP growth, and more importantly grew robustly in the second half with 7.4% growth in the third quarter and 4.2% growth in the fourth quarter. GDP continued its strong showing in the first quarter of 2004, up 4.5%, and grew moderately in the second quarter at 3.3%, rising slightly to 3.7% in the third quarter.[4] Furthermore, many signs are pointing to continued growth in 2004 and 2005, with the index of U.S. Leading Economic Indicators rising throughout 2003. It then continued to rise in 2004, growing 0.4% in January 2004, was flat in February, but then grew 0.8% in March, 0.1% in April, and 0.4% in May. However, it declined 0.1% in June 2004 and a further 0.3% in July and August,

[3] Bureau of Economic Analysis.
[4] Bureau of Economic Analysis.

falling to 115.7, and was down 0.1% to 115.6 in September. Although it declined recently, the overall trend over the past year is up.[5]

Personal incomes have also been rising, which is paramount to consumers for making investment and credit decisions. After years of growing at 5% to 8% in the late 1990s, personal income growth slowed to 1.8% in 2002 at $8.9 trillion. In 2003, personal income growth rebounded to a moderate rate of 3.2% to $9.2 trillion. In addition, growth in personal income was 4.6% year-over-year for the fourth quarter 2003, at an annual rate of $9.3 trillion, and continued to grow through the third quarter of 2004, to annual rate of $9.7 trillion.



Based on these trends, Advisen believes there will be moderate economic growth for this industry for the remainder of 2004 into 2005, subject of course to the usual provisos relating to the absence of catastrophic or unforeseen events, such as renewed terrorism or additional military actions, or Federal Reserve Board actions that substantially increase interest rates within a relatively short time period.

[5] The Conference Board.

Business Environment

Investment Banks and Securities Firms

The financial services industry is highly competitive and highly regulated. This industry and the global financial markets in which by necessity these participants operate are influenced by numerous unpredictable factors. These factors include world economic conditions, monetary and fiscal policies of companies and nations, the liquidity of global markets, international and regional political events, acts of war and terrorism, changes in applicable laws and regulations, the competitive environment, and investor sentiment, all of which are often difficult or impossible to quantify.

Google Has Lots of Zeros

Even after Google Inc.'s long-awaited initial public offering, investment bankers expect the IPO market will remain sluggish for the foreseeable future. Google has traded up considerably from its $85 offer price, to the delight of those who got in on the ground floor through its unconventional Dutch auction. Most of the other 18 IPOs that made it to market in August were forced to price below their initial target ranges. Some are trading below their offering prices. Such overwhelmingly negative sentiment spurred another 13 issuers to withdraw their deals and flee the IPO market altogether.

Even Google, which had been touted as a bellwether, has had little impact on the IPO market, despite the fact that it did manage to get its IPO done in an extremely difficult environment. Bankers don't expect any copycat offerings in the near future. With underwriters on the deal having found Google's auction process far too tedious and costly to justify the returns it brought them, most are actively discouraging other issuers from considering Dutch auction offerings. According to the bankers, very few issuers have expressed interest.

The complexity of Google's deal is also said to have raised questions about whether the price was an accurate reflection of what the auction process dictated, particularly since investors who didn't register for the offering before the company lowered its initial price range were ultimately excluded. In the end, despite Google's desire for active retail participation, bankers believe the percentage of retail investors who participated was actually smaller than most deals typically have.

Rebound May Be in the Offing

Investment bankers are optimistic that investor sentiment will turn, triggering a slow rebound. But the possibility of a terrorist attack remains and Iraq brings daily news of continuing violence and instability, making it unlikely that investors or issuers will dive back into the market in full force any time soon. Until then, bankers expect that new issues will remain sporadic. Not surprisingly, many underwriters have been advising issuers to remain on the sidelines a bit longer and wait until the heart of the fourth quarter before they try to tap the market.

As of third-quarter 2004, seven companies had already launched their road shows. They represent a wide array of sectors: Ness Technologies Inc., an IT company catering to international clients; StoneMor Partners LP, a company

that owns and operates more than 120 cemeteries; Gold Kist Holdings, an agricultural cooperative that markets chicken; Saxon REIT Inc., a real estate investment trust specializing in high-risk residential loans; Valley Bancorp, the holding company for the Las Vegas-based Valley Bank chain; CPFL Energy, one of Brazil's three largest energy distributors; and Educate Inc., the operator of primary school tutoring service Sylvan Learning Systems. Of those offerings, and the remainder in the IPO pipeline, no one deal stands out. Instead, bankers expect the offerings that will make it to market in the near future will be from strong companies in sectors across the board.

Building Firewalls

Most attention will be paid in the short-term to complying with the scandal-related settlement regulations and ensuring that the necessary firewalls are in place. But in the long-term, if reputations are to be restored, investment banks have to provide a better product at a lower cost. Up to now, analysts have been compensated and promoted according to the amount of new investment-banking business they have brought in and their rankings among institutional investors. Investment banks will now have to focus more closely on the value analysts provide to their clients, by monitoring things such as the long-term record of their investment recommendations. Researchers will need to shift from providing information to providing valuable insight. While good analysts have always provided original ideas, far too many researchers have based their jobs on packaging and massaging information.

But the appeal to investors of simple information has been limited by the coming of the Internet and the passing of Regulation FD (fair disclosure), which bars companies from leaking information selectively through analysts. That means undertaking much more in-depth work to generate fresh ideas. Research will now have to include proprietary views on how different industries will evolve and how that will affect each company. Investment banks will need to show how companies are perceived by their customers and also to analyze their balance sheets better.

There will likely be a continuing movement to outsource research. Most research arms of investment banks are now fully integrated: they collect data, build models, and produce investment recommendations. But much of the data collection work could be done more inexpensively in developing countries such as India. In addition, investment banks may form research partnerships with boutique consulting groups, specialized data providers, and others. That will allow banks to provide insight without having to foot the entire bill.

Mutual Funds Trying to Be Squeaky Clean

Even before the mutual fund scandals, Harvey L. Pitt, then chairman of the SEC, thought it would be a good idea to raise the bar on compliance. Under his leadership, the SEC proposed a wide-ranging new rule that will require funds and advisers to formalize their compliance procedures and empower a high-profile compliance czar. In the wake of market timing, late trading, and selective disclosure scandals, the SEC adopted that rule, and over the past few months, SEC staff members have fanned out to make sure the industry knows that compliance is serious business.

The new rules, which took effect October 5, require advisers to have written policies and procedures addressing the requirements of the Investment Advisers Act. Funds and their advisers have a heavier burden, as their policies

and procedures must address the requirements of seven different federal securities laws, known as the Seven Deadly Securities Laws. Many of the policies reflect traditional regulatory concerns; others, such as business recovery planning, reflect the staff's recent concern with operational compliance. All this has advisers and fund boards scrambling to get their houses in order.

The role of the new compliance czar, or chief compliance officer, is also a concern, as is how the rules affect relationships with various service providers. Senior managers use words such as monumental, nightmare, and daunting to describe their efforts to review existing compliance practices. The new rules require policies to be reasonably designed to prevent violations of laws. But many compliance experts caution that to be effective, policies must also detect and correct violations, and should provide for enforcement as well. Compliance officers describe an arduous process of analyzing risks, inventorying practices, and developing a matrix that connects the two. After that, they must document their practices, determine if they comply with all regulations, and fill in any gaps.

Industry Rocked by Image Problems and Loss of Public Confidence

The industry's image has been rocked by more than losses and layoffs. There has been a loss of trust. Trust was especially shaken in the executive suite, as the head of Credit Suisse First Boston's technology-banking group, Frank Quattrone, was forced to resign after refusing to testify before the NASD regarding allegedly unlawful business practices, including “spinning” and an alleged order to employees to “discard” certain documents.[6] He was later sentenced to 18 months in prison, in one of the harshest sentences ever by U.S. regulators against a prominent member of the financial services industry. The sentence was handed down in a federal court in New York after Quattrone had been found guilty of obstructing justice.

Investment banks also face the potential threat of investor lawsuits. Such suits would require plaintiffs to establish that analysts' recommendations moved the market, which is not an easy task. However, the reputational costs of contesting, and perhaps losing, such cases outweigh the possible fines, and investment banks may therefore be inclined to settle.

Consumer Finance

The success of companies in this industry is closely tied to the health of consumer spending, which in turn depends on general economic growth, low unemployment, low inflation, and low interest rates. When these factors are in sync, the industry does well. The industry suffers during recessions and other hard economic times when people are worried about keeping their jobs, inflation and interest rates shoot up, and consumer spending declines.

Interest rates are key to consumer behavior and the fortunes of the financial industry. As of the third-quarter of 2004, interest rates are heading upward, spurred by the Federal Reserve Board’s concerns over the potential reappearance of significant inflation. So far, increases have come in modest quarter-point increments, but the pace may increase if inflation rises faster than expected.

[6] "Quattrone Moves On; CSFB's Issues Remain," Wall Street Journal, March 5, 2003.

Credit quality is also a major concern in this industry, as the inability to repay loans is the principal source of financial loss. Consumer finance companies have historically provided loans to borrowers with poor credit histories, or lack of credit histories, that would likely result in their rejection by most banks. Many of these "marginal" borrowers come to this market because they have been turned down by banks. So the delinquency rate is expected to be higher than that experienced by banks.

Credit Cards

The staple of the consumer finance industry, credit cards, continues to spread throughout the country and throughout the world. According to *The Nilson Report*, approximately 1.36 billion credit cards have been issued, generating over $3 trillion in annual transactions worldwide. The U.S. alone accounts for about half of the cards and dollar volume of transactions.[7] The cards are issued by industry leaders such as Visa and MasterCard, which together make up about three-quarters of the market. Visa and MasterCard handle advertising and various administrative functions. However, the cards are issued by banks and other financial institutions (sometimes co-branded with affinity groups or major retailers), which set their own interest rates and terms of use.

A major shift in the credit card industry occurred when people who formerly used credit cards only for major purchases, and in emergencies when they were short of cash, started using them as a convenient way of making routine purchases, such as for groceries, gasoline, and clothing. Reward programs encouraging consumers to rack up points for free airfare or other benefits, and low introductory rates on new or transferred balances, have also been instrumental in expanding credit card usage. Also, there has been a vast expansion in the number of businesses and other organizations that accept credit cards as payment for merchandise and services.

Improved technology has made transactions faster and less expensive to process. For consumers that make purchases over the Internet, credit cards are usually the only viable way of paying. The downside of all this is that over-use or misuse of credit cards, along with their comparatively high interest rates (up to 20% or more), have led to an increase in consumer bankruptcies and write-off of bad debt as a percentage (usually 5% to 6% annually) of money owed.

Home Equity Loans

Companies that provide home equity loans often are used to bail out consumers with excessive credit card debt. These consumers take out a second or third mortgage on their home, and may then use that money to pay off credit cards or otherwise reduce their credit balances. Consumers can then make one monthly payment to the loan company, at a lower interest rate than they were paying to service multiple credit cards, and the interest may be tax deductible as mortgage interest. These companies and the companies that provide auto loans have the advantage of being secured creditors. So unlike credit card companies, they can foreclose on or repossess collateral properties if payments are not made.

A house isn't just a home, it is an investment, as far as many Americans are concerned. For too many, it is regarded as a money market account from which, through the magic of refinancing or home equity loans, they can

[7] "Diversified Financial Services," Standard & Poor's Industry Surveys, August 16, 2001.

make regular withdrawals to finance their desired living standard. The availability of home equity loans, and the tax deductibility of the interest on such loans, has further encouraged many homeowners to refinance their mortgages and spend all or part of their interest savings. Some have even spent part of the appreciation on their homes. Because home prices in the U.S. have appreciated by over half in the past six years and have marched upward without a break for almost 15 years, many homeowners have come to believe that their houses are high-yielding, risk-free investments.

That belief and historically low mortgage rates have encouraged some to buy ever-more-expensive homes and to invest even in second homes. But some of these homeowners don’t realize that their homes aren't risk-free investments. House prices don't march upward inevitably and forever, and can in fact decline. House prices can develop into a bubble, and the bubble can burst. A significant drop in house prices would hurt average Americans even more than the drop in stock prices in the 2000 to 2003 bear market because average Americans have more net worth invested in their houses than in stocks. Also, a significant increase in mortgage rates could be devastating for those who bought their homes with adjustable-rate mortgages. If they have borrowed too much, they could be forced into foreclosure. The resulting decline in home prices could hurt not only those who have over-invested in their homes, but the whole economy. It would sap confidence and choke off a large amount of consumer spending.

Even those who see the prices of their homes merely decline rather than appreciate would also likely cut back their spending. No doubt, that is one factor restraining the interest-raising urges of Federal Reserve Board Chairman Alan Greenspan. They may eventually need to raise interest rates to slow a speeding economy and control inflation, but so far, they have held off on large increases in favor of a gradual rise. In the meantime, investors must be reminded of the realities of homeownership. Yes, a home is an investment, but it should be a conservative investment providing most of its return in the form of shelter and not leveraged up in search of higher returns.

Regulation

Companies involved in consumer finance often operate similarly to banks, in that the bulk of their revenue comes from interest made on loans and fees related to loan transactions. As is the case with banks, companies in this industry must also establish reserves for potential loan defaults. However, these companies, while subject to many laws and regulations, are in general not as tightly regulated as banks, and can therefore be more flexible regarding products they offer and interest rates they charge.

Consumer finance firms must comply with state usury laws, which place upper limits on the interest rates that may be charged for various types of loans. They must also be vigilant about complying with federal and state laws protecting consumer credit privacy, requiring accurate disclosure of credit terms, and barring unlawful discrimination in extending credit. In addition, there are laws limiting the liability of credit card holders for unauthorized use of a card. There are also capital adequacy statutes designed to make certain that these companies are financially viable. If the company is in effect operating as a bank, it may be subject to banking regulations, including those of the Federal Reserve and FDIC.

Summary

The investment banking and securities sectors are in a prolonged campaign to regain investor and public confidence following a nightmarish airing of their dirty laundry. Regulators have descended on them with a vengeance, and compliance with the myriad new regulatory requirements consumes much of their time and resources. Surprisingly though, profitability has returned for many industry participants, even in the midst of this intense public scrutiny and regulatory oversight. Whether the industry has really learned its lesson, or whether it will return to questionable practices once the spotlight fades, remains to be seen. Now that the scandals *du jour* involve the insurance industry, the investment-related misdeeds seem like yesterday's news.

On the consumer finance side, gradually rising interest rates may put the breaks on consumer confidence and spending. The spate of mortgage refinancings may slow, and the red-hot housing market may cool off considerably. But consumers are unlikley to ever wean themselves from their credit cards, so that sector should do well, unless of course the high interest rates send more consumers into bankruptcy and make them unable to meet their obligations. The good news is that the job market is improving, so people should have enough money to live within their means. But few do choose to live within their means, much to the benefit of this sector.

Business Initiatives and Risks

Business initiatives and risks for investment banking and securities firms can be broken down into those involving strategic decisions relating to growth and expansion of the business, governance issues involving high-level policymaking and goal-setting, marketing and sales techniques that broaden the industry's reach both geographically and in terms of client focus, and compliance with government statutes and regulations in an era of diminishing trust.

The business initiatives and risks of the consumer finance industry mirror those of the banking industry. Searching for potential merger and acquisition partners, and making consolidations that have already occurred successful, are key to survival and prosperity. With the fall of the final barriers to entering other financial businesses, such as traditional banking, insurance, and investment-related operations, consumer finance firms have the go-ahead to diversify and expand, if their managements choose that course.

Strategy

Investment Banks and Securities Firms

Strategic alliances with other financial services companies, including foreign companies, are increasingly being seen as a way to obtain greater diversity and decrease overall risk. The alliances seem to be more with foreign companies (especially Asian) engaged in investment-related businesses, as opposed to taking advantage of the Gramm-Leach-Bliley Act to get into the U.S. commercial banking and insurance businesses.

Moreover, getting rid of analysts and other expensive people is only one way in which investment banks will need to save money. More difficult will be better use of technology. This was supposed to pose a threat to investment banks, but also provide a solution to some of their problems. Many tasks, such as back-office work, trading, and sales, could be done more inexpensively by machines than by people. Technology spending soared. However, despite the recent cost-cutting and well-publicized layoffs, the securities industry employs over a quarter of a million more people now than 10 years ago.

Even the investment banks admit they have invested poorly in technology. In the late 1990s, they duplicated traders and salespeople rather than replace them. And banks' chief investment officers have historically been cheerleaders for technology, not gatekeepers, and much of the spending was on must-have new kits for the whiz kids who made the money and were therefore hard to refuse. Banks are now trying to spend more wisely on technology, in part by moving information-technology jobs to places such as India.

Expansion into the Asian market, especially China, is very much on the radar screen of this industry. Although investment banking in Asia has in general been suffering through the same deal drought and layoffs as in the U.S., China has seen some notable activity. J.P. Morgan Chase is trying to build up its China investment banking staff. Goldman Sachs, Morgan Stanley, and Merrill Lynch have tended to dominate China deals in the past, but J.P. Morgan is hoping to raise its profile there. In the last couple of years, Deutsche Bank and CSFB have also tried to make inroads in China.

Investment banking firms want to advise Chinese companies on acquisitions and assist foreign companies eager to invest in China.[8] The lure of the Chinese market has changed since the late 1990s, when investment banks earned huge fees by taking public some of China's largest government-owned firms. Those deals are being replaced by a massive reorganization and consolidation of some of China's primary domestic industries. China's huge domestic market, now more accessible thanks to its membership in the World Trade Organization, is encouraging more multinational corporations to purchase stakes in Chinese ventures. [9]

Consumer Finance

Inevitably, the essence of strategic risk in consumer services is the decision whether to grow the business organically or grow through acquisitions and alliances. This growth can take place strictly within the current credit and financing business models, or can branch out into the banking and insurance realms.

Credit and loans are in effect high-class commodities, or at least they are in the eyes of most customers. No one seems to care where their mortgage money comes from, or which bank provides their credit cards, as long as they are getting the lowest interest rates and fees for which they qualify. Therefore, it makes sense to just go out and buy a going concern and avoid start-up costs if a company wants to expand into a new product or geographic area, as they are unlikely to come up with a home-grown product that blows away the competition. After all, how many new and untried ways can there be to make a loan or extend credit? It is easier to obtain someone else's customers through acquisition.

Consumer finance is a business in which there are many companies that have enjoyed success by carving out a niche, becoming specialists in that well-defined area, and developing a reputation for service, price, and quality that makes customers in that niche seek them out. Concentrating resources and going after clearly-defined target markets often results in economies of scale, permitting the company to undercut the prices of generalists offering the same or similar products and services. Of course, deciding which specializations to pursue, given current and projected future consumer financing needs, and developing a staff with expertise in those areas, are the keys to profitability in niche marketing.

Components of Strategic business initiatives include:

- Pursue growth through partnerships and alliances;
- Pursue growth through global expansion; and
- Increase focus on niches.

[8] "Some Banks Keen to Expand in China," Dow Jones Newswire, March 5, 2003.
[9] "Investment Banks Look to China," Wall Street Journal, March 5, 2003.

The following tables outline risks associated with these Strategic business initiatives.

Strategic	Operational
• Failure of acquisitions, joint ventures, or alliances • Ineffective business model/positioning strategy • New geographic initiative leads to regulatory and political exposures • New product/service fails in the market	• Inefficient operations render initiative unprofitable • Customer satisfaction suffers from poor service and support • Inadequate information processing systems create inefficiencies • Production/service quality suffers from low employee morale

Financial	Hazard
• Currency fluctuations cause earnings volatility in home currency • Inadequate cash flow to support daily operations • Exposure to financial market volatility through investments • Improper hedging techniques cause exposure to market volatility	• Theft/fraud by employees • Theft, robbery, or fraud by third parties • Lawsuits arising from performance or non-performance of professional services • Lawsuits from shareholders arising from errors or omissions of directors or officers

Marketing and Sales

Investment Banks and Securities Firms

The Gramm-Leach-Bliley Act opened the door for commercial banks to get into investment banking, and vice versa. As investment banking is generally more profitable than commercial banking (at least it is in a good

market), banks are garnering an increasing share of this business. Their strategy for winning this new business is often to provide clients with credit facilities, which investment banks traditionally have not done. This is somewhat disconcerting for the investment banks, as some clients are now demanding credit in return for mergers and acquisitions and underwriting engagements.[10] Investment banks will likely have to offer credit services if they are to compete.

A disconcerting (for investment bankers) McKinsey report notes that the return on equity of investment banks may drop by up to 30% if they provide all clients with credit.[11] Commercial banks, which already have credit capabilities in place, have an advantage over investment banks in this regard. On the other hand, it is the investment banks that have the underwriting expertise and access to potential investors. Whether these differences will spark a synergistic round of mergers between commercial and investment banks remains to be seen.

The McKinsey report also points out that market research shows that large corporations don't necessarily want one-stop shopping for commercial and investment banking needs. Rather, they tend to choose the “best of breed” in each product or service category. There is also the possibility that banks that bundle credit and investment banking will end up with high-risk borrowers, as corporations with difficulty obtaining lines of credit from traditional sources are the most likely to favor bundling. This may lead to credit losses that far outweigh the fees from investment banking.[12]

The wealthy will be with us always, and what a relief that is to every firm connected to financial services. Money needs to be invested, sheltered, protected, and hopefully multiplied, regardless of the state of the economy and the winds of war. For instance, out of Merrill Lynch's $1.2 trillion in client assets, two-thirds belong to clients with $1 million or more, according to the company's annual report. Firms in this industry are focusing their dwindling but still formidable resources on the needs of wealthy private investors, offering financial guidance and sophisticated solutions to simplify their clients' lives and more importantly, make the clients even more money.

To better service high net-worth clients, firms are creating training and accreditation for private wealth advisers, opening special offices designed and resourced exclusively for these clients, and establishing a premium service network dedicated to their needs. High-net-worth individuals do not reside exclusively in the U.S., and firms are making an effort to reach the wealthy wherever they may have a home, or homes.

Consumer Finance

Consumer finance companies’ marketing and sales efforts are often geared to specific niches in which they have special expertise and can offer the best products at the most competitive prices. These companies seek to obtain higher revenue and profits by increasing penetration of their existing markets with existing or new products and services. The principal sales distribution channels for these products and services are:

1. Direct mail – credit rating and other databases are screened for consumers with certain criteria, such as being part of a defined niche. The companies then mail these consumers offers for products such as credit cards or home equity loans that the criteria indicate they should have an interest in. The disadvantage of this method is that such “mass mailings” generally have low response rates.

[10] "The Limits of Bank Convergence," McKinsey Quarterly, 2002, No. 2.
[11] Ibid.
[12] Ibid.

2. Telemarketing – databases are screened and individuals with the desired criteria are identified and called directly and offered certain products they might be prone to buy. In addition, current customers may be cross-sold other company products. This method is generally more successful than direct mail, although also more expensive. Recent “do not call” legislation has reduced this method’s frequency and effectiveness.

3. Branch networks – these sell products in a specific geographic region and normally have office locations in high-traffic areas of the region in order to attract walk-in customers and service the existing local client base. This “bricks and mortar, face-to-face” approach is the most expensive marketing method, but it can also be the most successful because many times customers are already interested in the products, are seeking the company out, and are ready to do business if the price and other factors are “right.”

4. Event marketing – this usually involves setting up booths at trade shows or other events expected to be well-attended and to attract the type of prospects the company caters to. Promotional tie-ins, give-aways, and free samples or consultations can increase the success rate.

5. Retail outlets – the company will set up a small area in a large store and give out applications and/or brochures to prospective customers. This method works best in stores where high-cost items are sold and the customers need financing on the spot.

Management must fit marketing methods to the types of products being sold and types of clientele being sought. New products and newly-entered territories may require new types of sales initiatives. Initiatives that worked with one type of product or in a certain area may be an abject failure when used with products or in regions for which they are unsuited. If a particular marketing strategy isn’t working, it must be quickly replaced or supplemented to avoid losing market share to competitors.

Components of Marketing and Sales business initiatives include:

- Grow revenue through increased penetration of existing markets with existing products and services;
- Grow revenue through increased penetration of existing markets with new products and services;
- Grow revenue through penetration of new markets with existing products and services;
- Grow revenue through penetration of new markets with new products and services; and
- Grow market share through increased marketing efforts.

The following tables outline risks associated with these Marketing and Sales business initiatives.

Strategic	Operational
• New product/service fails in the market • Product obsolescence • New geographic initiative leads to regulatory and political exposures • Inadequate or ineffectual allocation of resources	• Inefficient operations render initiative unprofitable • Inadequate support causes products/services to fail • Customer satisfaction suffers from poor service and support • Inadequate information processing systems create inefficiencies

Financial	Hazard
• Large capital investments cause cash strain • Inadequate capital investments restrain future growth • Inadequate cash flow to support daily operations	• Lawsuits arising from contract disputes • Lawsuits arising from performance or non-performance of professional services • Lawsuits by shareholders arising from errors or omissions of directors or officers

Governance

Investment Banks and Securities Firms

Governance lapses were a key part of the scandals that mired this sector. Companies are taking actions designed to improve profitability, but are doing it legally, and hopefully ethically. They are becoming leaner, more competitive, and more focused on serving clients, by among other things:

(1) Conducting detailed reviews of each business to determine the appropriate sizing for the expected market environment. No longer is bigger always considered better. Markets must be studied in order to determine company resources to be allocated to those markets.

(2) Identifying businesses where margins and growth prospects are lower, focusing on areas of sustainable competitive advantage. Some companies are attempting to get into every business where they could conceivably eke out a dollar. Others are targeting their capabilities to niches where they have experience, an existing client base, an enviable reputation, or some other attribute that makes them stand out over the competition.

(3) Carving out opportunities to increase productivity and earnings through improved allocation of resources. In the bull market, opportunities came to the companies in this industry. Now the companies must seek out and go to the few available opportunities. Such opportunities may be right under the firm's nose, or in China, or somewhere else in the world.

(4) Focusing on ways to reshape client service, increase efficiency and accountability, and improve operating flexibility. Personal service is very much back in style. Investors are used to the immediate gratification that the Internet Age has come to symbolize. Service via the Web, call centers, dedicated and knowledgeable account executives - that is what clients in this industry feel they deserve, and what the successful participants are or will be providing.

Growth is the ultimate objective - whether in market share, clients, profitability, or opportunities. But it must be lawful and ethical growth, with none of the shenanigans of the previous high-flying era. Directors and officers of financial services firms must make sure that is so, in order to avoid mega-fines, litigation, and potential bankruptcy, as well as to preserve their own positions, assets, and reputations.

Consumer Finance

For consumer finance companies, assimilating acquired entities following mergers and acquisitions is often a paramount management focus. Hopefully, due diligence was adequately performed, and the entities are reveling in their synergistic advantages. The second best scenario would be that the merged companies are at least no worse off than they were pre-consolidation. If something goes terribly wrong, especially if there is a precipitous drop in the stock price, lawsuits will soon come knocking. In lieu of an outright combination, some firms may choose to form alliances and joint ventures to obtain the economic benefits of larger size or new customers or markets, without the permanence and potential liability that mergers entail.

In addition to consolidation-related issues, governance also encompasses the profitability of loan policies, credit-granting procedures, and investment portfolios; the company's relationship with its employees (especially if there have been consolidation-related layoffs); and other high-level policy issues. Such issues may include new businesses and territories to be entered or exited, new products to be offered, and new technologies to be implemented, as well as any other method or strategy by which the company can enjoy profits or suffer losses.

Components of Governance business initiatives include:

- Restructure the organization/streamline bureaucracy; and

- Develop strategic alliances and partnerships with synergistic organizations.

The following tables outline risks associated with these Governance business initiatives:

Strategic	Operational
• New product/service fails in the market • New geographic initiative leads to regulatory and political exposures • Failure of acquisitions, joint ventures, or alliances	• Inefficient operations render initiative unprofitable • Oversized overhead renders initiative unprofitable • Inadequate information processing systems create inefficiencies

Financial	Hazard
• Currency fluctuations cause earnings volatility in home currency • Exposure to financial market volatility through investments • Improper hedging techniques cause exposure to market volatility	• Lawsuits arising from employment-related activities • Lawsuits by shareholders arising from errors or omissions of directors or officers • Liability assumed by contract

Compliance

Investment Banks and Securities Firms

The scandals and their aftermath have focused legislative and SEC attention on reforming the ways corporations raise and use money, as well as protecting investors from financial ruin. As the prime conduits for raising capital and investing, investment banks and securities firms are, and can expect to continue to be, under the regulatory microscope. They must remain vigilant about complying with the myriad federal and state laws and regulations regarding disclosure, avoidance of conflicts of interest, and adherence to accounting standards.

There have been dramatic changes in the legal and regulatory environment in the financial services industry during the past two years. The New York Stock Exchange proposed new corporate governance rules. U.S. regulators mandated CEO and CFO certification of corporate financial statements. Law enforcement agencies

began aggressive enforcement actions aimed at misconduct. And Congress passed the Sarbanes-Oxley Act in an attempt to strengthen confidence in U.S. corporations, corporate accounting, and financial markets.

Some firms in the investment banking industry, including CSFB, Morgan Stanley, Lehman Brothers, and Goldman Sachs, that have had to pay massive government fines are making a major push to recoup these losses from their directors' and officers' liability insurers. Most of these fines relate to research conflicts of interest and "spinning" violations. The research-related fines alone total about $1.4 billion, and the investment banking firms hope to recover up to 40% of that from their insurers. Insurance companies are resisting paying out on these claims, arguing that the losses stem from intentional misconduct, which is excluded by most policies.[13]

As part of the settlement, 10 banks agreed to wide-ranging changes, including physical and financial separation of research from investment banking, increased disclosure on research material and the provision of independent, third-party research. Among other changes, equity research analysts now have to get approval from a "research recommendation committee" before they can initiate coverage of a new stock. Analysts have also been banned from attending meetings when investment bankers were pitching underwriting business.

The SEC is engaging in more aggressive, proactive measures in investigating potential securities law violations. It is spending less time investigating and negotiating, whether formally or informally, before bringing enforcement actions. It is likely to name more defendants or respondents than in the past. And the SEC is litigating cases with greater zeal, frequency, and speed. One of the mainstays of SEC enforcement practice, the ability to settle a matter without admitting or denying the SEC's allegations, is reportedly under critical review by the SEC's staff.

The SEC is also imposing substantial penalties on companies, individuals, and third parties who fail to comply promptly or completely with subpoenas or fail to cooperate in investigations. To be considered cooperative, companies must not only produce documents and information quickly and completely, but may also be pressured by the staff to waive the attorney/client and work-product privileges and produce internal investigation reports to the SEC, take decisive action to punish wrongdoers, and deny any indemnification for defense costs to its employees when indemnification is not mandatory.

Consumer Finance

As in other industries, improper or downright shady accounting practices in the consumer finance industry have been the source of dreadful publicity and monumental liability for corporate directors and officers. One of the largest D&O insurance payouts to date involved a financial services firm, Cendant. Management has a fiduciary obligation to make certain that that the proper accounting standards are followed. These standards should accurately reflect operations and follow federal- and state-mandated requirements. Failure to do so may result in the necessity of making adjustments or restatements. Many executives have ruefully discovered that restatements are to plaintiff securities attorneys what blood is to sharks.

Consumer finance is an industry affected with the public interest and is important to the national economy, and it is therefore closely regulated. Firms in this industry must be especially vigilant about avoiding discriminatory lending and credit practices and respecting consumer privacy. Remaining current and in compliance with the myriad of statutes regulating consumer finance is a difficult task, and one where the punishments for non-

[13] "Insurers Refuse to Pay Bank Fraud Liability Claims," New York Post, March 18, 2003.

compliance may be severe, including the most dreaded of all - class action litigation by consumer groups alleging unlawful bias or charging of excessive rates or fees.

Components of Compliance business initiatives include:

- Review appropriateness of accounting standards; and
- Review compliance procedures to ensure compliance to regulations.

The following table outlines risks associated with these Compliance business initiatives.

Strategic	Operational
• Business initiative damages company's reputation • New geographic initiative leads to regulatory and political exposures	• Compliance procedures breakdown creates liability exposure • Lack of training causes misuse of company assets • Breakdown of internal controls

Financial	Hazard
• Improper financial statement disclosures and accounting standards • Tax policy does not optimize latest tax code changes	• Theft/fraud by employees • Lawsuits by shareholders arising from errors or omissions of directors or officers