

Final look

A practical guide to the
Federal Reserve's enhanced
prudential standards
for domestic banks



Foreword

Two years into the process, domestic banks—particularly those with more than \$50 billion in consolidated assets—are unlikely to find many surprises in the recent Federal Reserve (Fed) announcement on the final enhanced prudential standards (EPS) rules. Banks may already be moving down the path laid out by the Fed, particularly in the areas of capital planning, stress testing, liquidity risk management, and risk governance. Although continuing improvements and additional oversight by the board and senior management will be required, the Fed has already adopted many of these requirements (in areas such as stress testing) as part of its current supervisory toolkit.

Many U.S. banks are already turning their attention to other areas as they bid to become stronger in risk and compliance. They are looking for ways to strengthen their risk governance practices. They're expanding their capabilities in the area of data, from data aggregation and reporting to enhanced risk analytics. They are reexamining and strengthening specific roles, with a special focus on the chief risk officer (CRO) and risk committee of the board. They are building out more formal compliance programs to support the initiatives that have already been developed. The goal is also to eventually make the compliance programs that support these regulations and requirements part of business as usual throughout the organization. On all of these fronts, plenty of progress remains to be made.

The final rules may likely bring challenges to some institutions, particularly when it comes to establishing the oversight, procedures, controls, and data infrastructure needed to fully comply with the rules. Meanwhile, other banks are already on their way toward meeting these requirements and enhancing their practices beyond these minimum requirements, using enhanced capital, risk management, and liquidity practices to rethink their business strategies and rationalize their products and booking. In this light, the approval of EPS represents a significant step on the part of the Fed toward improving the framework for supervising and regulating large banks—and addressing the risks that large banks may pose to the financial stability of the U.S.

In this document, we have prepared a summary of key points contained in the final EPS regulation. *While this should not replace your own thorough review of the rule*, it is designed to serve as a primer for understanding its potential.

At a glance

Here are several high-level takeaways of note for those comparing the proposed rules to the final rules for domestic banks:

- The final rules are largely consistent with proposed rules issued in December 2011. In fact, the U.S. top-tier bank holding companies (BHC) have been moving toward these requirements over the past two years. The final date for implementation is January 1, 2015.
- U.S. BHCs should expect a continued focus on risk governance, distinguishing among roles and responsibilities across the three lines of defense, and risk analytics, aggregation, and reporting across the entire organization.
- Nonbank financial companies were scoped out of the final rules, and the Fed expects to apply EPS to individual nonbank financial companies by rule or order; however, the requirements were explicitly extended to savings and loan holding companies.
- Single counterparty credit limits (SCCL) will be re-scoped and aligned to international efforts. They will take into consideration the results of two quantitative impact studies and are expected to be released later this year.
- Early remediation requirements are still under development and are not included in the final rules.
- Enhanced risk-based and leverage capital requirements and stress testing requirements for large BHCs were previously adopted.
- Liquidity requirements were confirmed including liquidity risk management standards, internal liquidity stress tests, and a 30-day buffer of highly liquid assets.
- Risk management requirements were confirmed and include guidelines on appointing a CRO and establishing an enterprise-wide risk committee that meets at least quarterly and has at least one independent director knowledgeable of risk management.
- Stress testing requirements explicitly state that the board and senior management are accountable for consideration of the results of the stress test on capital planning, assessment of capital adequacy and risk management, and strengthened requirements to publicly disclose results.

Scoping considerations

U.S. BHCs with more than \$50 billion in consolidated assets are required by the final rule at a summary level to comply with risk management and qualitative liquidity standards. In addition, publicly traded U.S. BHCs with more than \$10 billion in total consolidated assets are required by the final rule to establish a risk committee of the board of directors to oversee its risk management framework.

Timing considerations

Generally, a U.S. BHC with more than \$50 billion in consolidated assets will become subject to risk management and qualitative liquidity standards beginning on January 1, 2015. In addition, publicly traded BHCs with more than \$10 billion in assets will become subject to the risk committee requirement beginning on July 1, 2015.

Capital requirements

Changes and implications in 2014

The final EPS rules for domestic banks are unchanged from the proposal finalizing risk-based capital and leverage requirements (as laid out in the Basel III rules finalized in July 2013) for small and large domestic banks.

Both large and small domestic BHCs will be required to maintain higher capital levels and capital ratios to comply with the Fed's risk capital rules, i.e., U.S. Basel III. Among these provisions, BHCs with less than \$250 billion in assets will be subject to standardized approach rules, while BHCs with \$250 billion or more in assets—or at least \$10 billion in foreign exposures—will need to comply with advanced approach rules. Advanced approach banks must also compute capital ratios based on the standardized approach.

The new rules also include increased minimum capital requirements and buffers intended to increase the quantity of regulatory capital as well as new capital tier definitions and deductions that aim to increase the quality of that regulatory capital. Banks with more than \$50 billion in assets are also subject to enhanced requirements for both capital and public disclosures. New requirements for quarterly calculation and disclosures—including the need to source, process, and report data—will likely impose new challenges.

As they move ahead, banks should consider a number of specific implications, including:

- The Fed is reviewing comments on a proposal that would require large BHCs to maintain a buffer of 2 percent or more above the minimum supplementary leverage ratio requirement of 3 percent. Other proposals may be made to enhance risk-based capital rules for large BHCs, including a quantitative risk-based capital surcharge.
- Because of the minimum leverage ratio of 4 percent and common equity Tier 1 ratio of 4.5 percent, as well as additional buffers in the form of capital conservation and countercyclical buffers, institutions are likely to continue to face pressure to raise capital, divest noncore businesses, and hold a better quality of capital. Banks will face significant challenges in balancing the conflicting requirements posed by leverage ratio requirements and other requirements such as liquidity coverage.
- Nonbank financial companies designated by the Financial Stability Oversight Council will not be required to comply with the final rules. Instead, the Fed will further assess the business models and risk profiles of designated nonbank financial companies and will determine how EPS should be applied to each company or category of companies. Large nonbank financial companies that expect to be designated systemically important will also continue to face pressure to improve the quantity and quality of regulatory capital.
- Adhering to the new rules will likely introduce new challenges in the areas of people, process, and technology, including:
 - Changes to processes for enabling timely and accurate filing.
 - Creation of data sourcing and processing infrastructures for risk-weighted asset calculations (especially for counterparty and securitizations portfolios).
 - Hiring and training of personnel with appropriate functional and technical skills.

Our take

Both advanced and standardized banks have already been improving the processes and controls surrounding their regulatory capital processes. This includes building on existing calculation processes, revising workflows, sourcing data through automated data feeds, and developing enhanced accountability, review, and sign-off processes.

Due to the risk-based capital floor, advanced banks will have to calculate capital using both the standardized and advanced approaches. So these banks (and many others) are looking to migrate their standardized and advanced calculations onto a single platform, using the same data, calculations, and controls where possible.

Many large U.S. BHCs have progressed toward meeting these increased capital levels in anticipation of these rules. The expected introduction of additional buffers to the minimum leverage ratio and minimum risk-based capital ratios for larger banks may continue that trend.

Liquidity requirements

Changes and implications in 2014

The final rules retain many of the same liquidity requirements that were included in the proposed standards, with some changes and adjustments. They clarify the definition of unencumbered assets, going on to state that hedges can be included in the liquidity buffer. Additionally, assets pledged to the central bank can be included in the liquidity buffer—but those held at central counterparties (CCPs) in excess of what is required cannot be included.

Following are several additional implications of the final rules:

- While a bank's board is still responsible for the oversight of liquidity risk management, the final rules assign certain risk management responsibilities to senior management. The board is still required to review the bank's liquidity risk tolerance at least annually, to receive and review information from senior management at least semiannually, and to approve and periodically review liquidity risk management strategies, policies, and procedures. But in a departure from proposed rules, the final rules assign responsibility for reviewing and approving contingency funding plans to the risk committee.
- The final liquidity rules require a BHC to:
 - *Establish and maintain an independent review function to evaluate liquidity risk management.* The review would be conducted at least once a year and would result in a written report to the board that specifies regulatory or statutory noncompliance as well as material issues.
 - *Perform cash flow projections and liquidity stress testing.* These should include cash flows arising from contractual maturities and new business, funding renewals, contingencies, and off-balance-sheet commitments that may affect liquidity. Liquidity stress testing should occur monthly—and perhaps even more frequently, depending on circumstances.
 - *Validate methodologies, assumptions, and processes regarding cash flow projections and stress testing by an independent review function.*
 - *Establish and maintain a contingency funding plan.* The rules specify that the plan should include four components: a quantitative assessment, an event management process, monitoring requirements, and testing requirements. All requirements are considered fairly stringent.
 - *Monitor liquidity risk related to collateral positions, including:*
 - > Determining collateral positions in a timely manner.
 - > Identifying the nature and degree of encumbrance.
 - > Monitoring levels of available collateral by legal entity, jurisdiction, and currency.
 - > Monitoring shifts between intraday, overnight, and term pledging of collateral.
 - *Establish and maintain capabilities for monitoring intraday liquidity risk exposure* (for BHCs engaged in significant payment, settlement, or clearing activities).
 - *Maintain a liquidity buffer of unencumbered, highly liquid assets.* These assets should be sufficient to meet projected net cash flow outflows and projected loss or impairment of existing funding sources for 30 days.

Looking back, it seems clear that the requirements contained in the proposed standards represented the first stage of establishing a regulatory liquidity framework for large banking institutions. The quantitative requirements of the proposed U.S. Basel III liquidity coverage ratio (LCR) requirements were the second stage. The requirements of the final EPS rules are intended to complement the proposed LCR requirements.

Our take

The governance requirements of the final rules regarding liquidity will be familiar to many institutions that have already taken steps toward implementation. Some of these institutions may still lack the processes and technology needed to fully support the other provisions. They should consider whether this requires continued investment (and in some cases *new investments*) in areas such as reporting and stress testing—areas where the downstream delivery of granular, high-quality data continues to be a challenge.

The liquidity buffer requirement in particular is likely to impose a significant cost on banks—one that may have a direct impact on profitability and overall business strategy.

Single counterparty credit limit requirements

Changes and implications in 2014

The final rules do not specifically address single counterparty credit limits (SCCLs). Instead, SCCLs will be re-scoped and aligned to international efforts. The Fed may determine more analysis is required. It will likely take into consideration the results of two quantitative impact studies, expected to be released later this year, to evaluate whether and to what extent specific proposed counterparty limits will affect credit availability.

Our take

As part of upgrades to their systems, banks have been making significant changes to their back-office systems, middle-office systems, and capital calculators so they can capture credit data they need to monitor and report exposure to counterparties and CCPs. This data includes trade type, trade positions, initial margin, variation margin, and other categories.

In addition, banks may have already implemented or may be in the process of implementing formal enterprise-wide policies that outline credit management and supervisory practices for approving and monitoring credit risk associated with regulated clearinghouses and exchanges. This includes due diligence requirements for risk ratings and exposure thresholds and limits. In advance of the final rules, we anticipate many banks will need to leverage their existing efforts to enhance their risk management systems and further make the transition from thresholds to hard limits. Many are reviewing their individual limits for each CCP and counterparty as part of annual reviews. Banks are also planning to implement aggregated CCP exposure limits.

Risk management requirements

Changes and implications in 2014

The final rules differ from the proposed rules in several ways regarding risk committees and include separate rules depending on the size of the bank. Some highlights:

For publicly traded BHCs with consolidated assets of \$10 billion or more:

- The risk committee must be chaired by an independent director.
- There are additional criteria for individuals to be considered independent directors of BHCs.
- The risk committee is expected to approve and review the risk management policies of the global operations of the BHC.
- Risk committee meetings should occur quarterly, rather than “regularly.”
- The experience requirements for at least one director of the committee have been revised to specify experience in identifying, assessing, and managing risk exposures of large, complex banks.
- The board of directors, or a committee of the board, is now responsible for approving and reviewing the policies and procedures of stress testing processes as frequently as economic conditions warrant.
- All risk committee requirements must be complied with by July 2015.

For BHCs with consolidated assets of \$50 billion or more:

- The risk committee must be an independent committee of the board of directors and should have exclusive oversight for the risk management policies of the BHC’s global operations, as well as oversight of its global risk management framework.
- Risk committee meetings should occur quarterly, rather than “regularly.”
- The experience requirements for at least one director of the committee have been revised to specify experience in identifying, assessing, and managing risk exposures of large, complex banks.
- The risk committee is now responsible for oversight of liquidity risk management and is expected to approve the contingency funding plan at least annually, along with any material revisions to the plan.
- The board is expected to approve (rather than establish) the bank’s risk tolerance at least annually.
- Senior management must report to the board at least quarterly on the BHC’s liquidity risk profile and liquidity risk tolerance.
- The CRO is now expected to have experience in identifying, assessing, and managing risk exposures of large, complex banks.
- The CRO is now expected to provide “oversight” of risk responsibilities that could be performed by other functions or units.
- The BHC must provide compensation and other incentives to the CRO consistent with providing an objective assessment of the risks taken by the BHC.

The final rules will affect companies at the board, risk committee, and executive management levels, especially when it comes to risk committee composition, procedural requirements, and requirements related to the establishment, expertise, reporting lines, compensation, and incentives of the CRO. If a company already has a risk committee and a CRO, it will likely need to assess CRO qualifications, stature, compensation, and positioning in the bank.

Banks that may have less developed formal global risk management frameworks are likely to be affected the most. For those banks, the CRO and risk management function should consider driving the design, development, and implementation of the framework.

Either way, expect data and infrastructure to play big roles in compliance. Both will likely need to be upgraded to meet the demands of an integrated, enterprise-wide risk analysis.

Our take

The new rules have primary effects that institutions can easily see coming, such as framework and governance requirements and the need to staff CRO and board risk committee positions. However, there are also secondary effects that institutions need to take into consideration. Talent and compensation strategies are part of this framework. So are data availability, analytics, monitoring, and reporting capabilities.

Companies will need to understand the potential ways that the practical application of the new rules will affect activities and operations throughout the organization. This is especially true among BHCs with greater than \$10 billion in assets, and it is even more pronounced for BHCs with greater than \$50 billion in assets for whom risk management and risk committee requirements will be more stringent.

The final rules may require companies to evaluate their risk programs and assess their compliance with EPS requirements. Even if a company already has a risk committee, it will probably have to reevaluate that committee's composition and consider other substantial changes.

Stress testing requirements

Changes and implications in 2014

The domestic stress testing rules became final in October 2012, so these institutions have already been applying the stress test requirements. The requirements are scaled to bank size, with increased expectations for the largest top-tier banks.

In the wake of these rules, banks should consider a number of specific implications, including:

- Banks with \$10-50 billion in assets will be complying with these rules for the first time. Many smaller institutions will find the technology requirements to be onerous. New stress testing requirements will likely lead to additional investments in human capital and organizational infrastructure to support the effort. Integration into a bank's decision-making process will simply take time. The learning curve tends to be steep, and it could take a while to understand the scope and implications of these requirements.
- While banks with more than \$50 billion in assets have already been through the stress testing process, they will likely need to continue to refine the process as regulatory expectations increase.
- Many new EPS requirements have a direct connection to stress testing. That means banks must consider how to coordinate their stress testing efforts with other EPS provisions. The following are some notable points of intersection with these separate provisions:
 - **Risk management and risk committee** requirements demand a specific risk committee structure that will impact the governance of the stress testing process.
 - **Liquidity requirements** can impact capital distributions and require that assumptions regarding liquidity within capital planning are coordinated.
 - **Risk-based capital requirements** and proposed **leverage limits** include capital minimums that have to be factored into capital plans.
 - **Early remediation requirements**, while currently deferred, will tie stress tests and minimum capital ratios to specific actions for covered companies. Since many actions are mandated as a result, they will need to be considered within the capital planning process—including stress testing.
- Data infrastructures will need to be coordinated with other regulatory requirements with data capture and control processes strengthened and able to respond to changing requirements—which means flexibility and agility will be required.
- Risk frameworks will also need to be coordinated between the holding company level and the subsidiary levels—for example, with the Office of the Comptroller of the Currency's (OCC) proposed rulemaking regarding "heightened expectations."¹

Our take

Expectations continue to ramp up—so institutions affected by these rules need to continue building and evolving their stress testing processes. As they plan around the issues of stress testing and capital planning, these institutions should consider avoiding planning in silos; integration with related EPS requirements is expected by regulators. This is likely to influence how institutions coordinate their risk, finance, and treasury functions and so is likely to add a new layer of complexity to existing stress testing implementation.

Regardless of a bank's size, governance and controls related to stress testing will also be a subject of considerable scrutiny as regulators look to validate the integrity of the process. As a practical matter, institutions can expect EPS-related implementation costs to remain high, despite the fact that stress testing processes are already in place. Those institutions that have amassed the greatest amount of experience in stress testing to date will likely find integration with related requirements to be less difficult.

¹ Refer to OCC release. <http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-4.html>.

Early remediation requirements

Changes and implications in 2014

The Fed has delayed issuing final rules for early remediation, likely due to unfolding developments regarding single point of entry, global loss absorption capacity, the Fed's recovery requirements, the Fed's capabilities requirements, and (for foreign banking organizations) the development of international recovery approaches.

The Fed continues to review comments and is participating with the Basel Committee in developing a large exposure regime, which would inform its decisions around single counterparty credit limits. Because early remediation requirements are tied closely to these limits from an event triggering perspective, it is not surprising that one has delayed the other.

As soon as new rules are issued, we will provide our thoughts on the implications.

Our take

The Fed's decision to delay this section and await further guidance from the Basel Committee appears to offer further evidence of U.S. banking regulators attempting to work more closely with the global bank regulatory community. The U.S. has been criticized in the past for moving in a direction that does not align to discussions underway in the global arena. We expect the Fed to continue this forward-looking approach to regulation, and we consider this delay to be part of a strengthening of the global approach, coordination with domestic rules, an opportunity to push out certain portions of the regulation due to ongoing debates—or some combination of all of those. Either way, this allows banks continuing opportunities to voice concerns regarding the original proposed approach to early remediation.

The data imperative

It goes without saying that data is the lifeblood of many new rules. As a result, the final U.S. rules regarding data seek increased frequency and granularity in regulatory reporting. They also prescribe an approach to organizational and legal entity structure, as well as governance processes and reporting functions.

The new rules also include some notable changes—including the new levels of data reporting included in the FR 2052a and FR 2052b² proposed rules—affecting all domestic institutions with assets of \$10 billion or more. Regardless, banking institutions should expect data infrastructure and design to play a major role in compliance, because current systems may not have the capacity to deliver information in a manner befitting the new rules. Given the sweeping reach of these regulations, a holistic, enterprise-level approach to compliance will be necessary. For example, data sourcing and design will need to take place at the enterprise level, because many rules imply cross-functional coordination.

Changes and implications in 2014

The new rules make it clear that as important as data has been in recent years, it is of even greater importance to regulators today. Here are some key implications for domestic banking institutions:

- Domestic banks should plan for a greater focus on data governance and data management systems, including organizational governance and data management oversight. Improved processes for data attestation and control imply an increasing need for participation from front and middle offices. Additional technologies, including data warehouses, may be required for effective and efficient compliance.
- Regulators are increasingly requesting greater granularity of data—by product type, region, business division, and more—in order to make sure it aligns with required financial reporting.
- The issue of “materiality” appears to be increasingly irrelevant. Instead, regulators have higher expectations for overall data quality.
- It is becoming increasingly clear that regulators expect each bank to have an in-house team with expertise in regulatory matters and with the support of clear internal policies. This may require additional human capital and infrastructure investments.
- Increased involvement from front and middle offices suggests additional pressure on people who are already highly knowledgeable about data. As a result, these employees will face greater demands on their time—demands that may be unsustainable. To avoid attrition, institutions may need to give these resources additional support.

² “Data Collections Currently under Review by the Board of Governors of the Federal Reserve System,” March 6, 2014, <http://www.federalreserve.gov/apps/reportforms/review.aspx>.

Our take

Data management, already a hot-button issue at domestic banks, will likely remain a significant focus within the C-suite, among the board, and beyond. Leaders in banks should seek ways to expand this focus. After all, data is an integral component of every rule finalized as part of EPS.

As they expand their focus, leaders may find it useful to consider what has worked in recent years—and what hasn't—as banks have taken on the challenge of increased data standards. For example, data governance and data quality functions have been implemented with wide-ranging success, leading to a real shift in how data is gathered, accessed, and used. In particular, front- and middle-office employees with specific, specialized data knowledge have been identified as valuable resources in data-focused efforts.

Infrastructure has also taken on new importance, to the benefit of many banking organizations. Data warehouses, ETL (extract, transform, load processes), and reporting and visualization tools have made data more accessible and actionable.

What hasn't worked? Tactical responses to regulatory reporting in the area of organizational functions and infrastructure have fallen short for many banks. Similarly, banks that have applied broad materiality thresholds have, in many cases, not seen the desired results from these efforts in terms of data quality.

Banking institutions that started addressing their data challenges under proposed rules have an advantage over those that may have held out on their planning and implementation efforts. Given the complexity and importance of data as part of broader compliance efforts—not to mention its central role in business strategy and operations—now is the time for all banks to make sure data receives their full attention.

Ready, set...go

For many banks, it is easy to find comfort in these rules—partly because those banks have been pursuing many of these activities already, and partly because the rules bring a new level of certainty to regulatory issues. These are welcome developments.

But at the same time, it's important that banks are not lulled into complacency. These rules require strong capabilities in the areas of data, process, control, infrastructure, and more. In those areas, many banks still have a long way to go to—and not much time to get there.

One good place to start is with a gap assessment. While there are few significant points of divergence from the proposed rules, the changes presented by the final rules could be serious enough to trip up banks on the path to compliance. In this document, we have identified some of the most important changes. At the same time, building compliance programs that explicitly connect requirements to controls will be key. Building compliance, monitoring, and testing processes to review the compliance requirements on a periodic basis will be equally important.

Given the rising importance of risk management as a core component of a “strong” business strategy, banks that take the lead in complying with the final EPS rules are likely to find that, in addition to mere compliance, they emerge with an enhanced risk management framework and governance structure that is proactive and tied more explicitly to business strategy. Our recent experience indicates there is wide variation among banks in terms of their levels of preparation for these rules. Whether your bank is behind the curve or setting the pace, the race is on.

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