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Final look

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

Produced by the Deloitte Center for Regulatory Strategies

Foreword

As foreign banking organizations (FBOs) gain familiarity with the final enhanced prudential standards (EPS) the Federal Reserve Board (Fed) announced more than one year after the proposal, FBOs are likely to conclude that these rules usher in a new era of supervision and enforcement. After nearly a decade of the Fed administering its supervisory program for FBOs, these regulations mark a significant landmark in its oversight of foreign banks' operations in the United States. While the Fed's statements in past years have pointed the way to a more vigorous role in regulating FBOs through its supervisory process, these more prescriptive rules finally make it official.

Leaders at FBOs will find many instances in which the Fed appears to have listened to the industry. In the final rules, it seems clear one size does not fit all—and that should come as a relief to FBOs. The Fed has built flexibility into the rules to account for foreign banks of different sizes and complexity that operate differently in the U.S. The most significant changes come to those with significant U.S. operations in the form of existing legal entities, rather than only branches or agencies of a parent bank.

The most significant mandate in the final rules concerns the legal entity form for the FBOs with the largest U.S. operations and imposes U.S. capital and liquidity requirements on those operations. Using the intermediate holding company (IHC) structure, these FBOs are expected to comply with many of the same regulations that large U.S. banking organizations already must follow or are expected to follow. To achieve these goals, many organizations may need to inject significant additional captive capital and funding into U.S. operations that are complemented by investment in U.S. infrastructure—including systems, data, governance, risk management, and reporting. It may be necessary to update these infrastructures to meet different standards, rethink and reengineer processes, and much more.

FBOs that are not required to form an IHC will still have to satisfy risk management, governance, and liquidity risk requirements, which will likely require close coordination between their parent banks and their U.S. presence.

The timeline for implementation should also come as a relief. FBOs have another year (until July 2016) in which to pursue implementation. In addition, there are transition timelines for the most complex components of the regulation, such as leverage ratio, capital stress testing, and IHC formation. These rules may require significant time, effort, and resources in both in the U.S. and at parent banks to build these capabilities.

The broader regulatory landscape

These final rules are not the only regulations that will need a close watch. FBOs should closely monitor other, related regulatory developments [such as Federal Reserve Supervision and Regulation Letter - SR12-17[1] and the Office of the Comptroller of the Currency's (OCC) release for heightened expectations]. In addition, future rule-making is expected [this includes rule-making around leverage coverage ratio, global systemically important financial institution capital surcharge, long-term loss-absorbing debt requirement, wholesale funding, net stable funding ratio liquidity requirement, single-counterparty credit limits (SCCLs), and early remediation]. These developments should be considered in the EPS timeline, and many FBOs will likely have to track internal initiatives from their parent banks and home-country regulators as well.

IHC strategy and structure

Branches and agencies of the parent bank continue to be excluded from the IHC structure. As such, we expect a continuation of the current regulatory focus on any movements of businesses, products, or assets between legal entities in the U.S. Given the additional time afforded by the conformance period for a leverage ratio, and the additional requirement for development of an implementation plan for quarterly monitoring of balance sheet and capital impacts, FBOs should also reassess their balance sheet optimization strategies to streamline their capital and liquidity impacts. It should also be noted that these rules provide additional clarity on the formation of an IHC. FBOs will need to align nearly all of their legal entity structures by July 2016, with some transition period for residual interests by July 2017.

As they waited for the Fed to finalize the EPS standards, some FBOs appear to have been rethinking their business strategies to determine how they want their U.S. businesses across banking and nonbanking activities to be positioned and to align strategically to their parent bank plans. Those FBOs that have chosen to evaluate booking practices as part of their global strategy and positioning to streamline their operations should consider their modeling capabilities and the linkage between global and regional strategies.

Global and regional alignment
A strong linkage with the parent bank is important. This is not just a U.S. exercise. An FBO will likely need a centralized governance design process to integrate views on capital, tax, liquidity and funding, legal entity structural considerations, and risk management. FBOs will also likely need to draw upon key global resources, particularly for the most complex areas and where, traditionally, strong global vertical alignment has taken place.

Implementation planning
The required implementation plan for IHC formation should prescribe the structuring and sequencing of the pro forma legal entity structure, financials, capital impact and strategies, and the alignment of risk management liquidity stress testing practices to requirements. Each affected FBO should consider the timing of strategic business decisions that must be made and incorporated into the plans with an expectation for close monitoring of these plans through the implementation timelines. This effort will require consideration of legal entity structures, the associated business alignment to the legal entity structure, and an evaluation of governance, risk management, and operational implications. Consequently, a number of design decisions will likely need to be made and will require continued close coordination between U.S. and parent bank management teams.

Competitive outlook
The threshold change for the creation of an IHC (required only for U.S. non-branch assets that exceed $50 billion) draws a clear line in the sand for smaller and mid-sized FBOs that may want to avoid significant EPS requirements.

The approval of the EPS represents a significant step on the part of the Fed toward improving the framework for supervising and regulating large financial institutions, both domestic and foreign. It addresses the risks that large financial institutions could pose to the financial stability of the U.S. These final rules will likely jump-start much of the preplanning and analysis efforts that FBOs have taken on to date. The race for implementation is next.

While this document should not replace your own thorough review of the rule, it is designed to serve as a primer for understanding the rule's potential impact as quickly as possible.

Key changes between proposed and final rules

The final rules are quite consistent with key aspects of the proposed rules, except in the following areas:

- The **implementation date has been extended** to July 2016, with additional timing relief on certain components (leverage ratio requirements aligned to international standards to January 2018, CCAR transition period beginning October 2016)
- **SCCLs will be re-scoped** and aligned to international efforts, with consideration for the results of quantitative impact studies
- **Early remediation requirements are still under development** and are not included in the final rule
- Advanced model approaches for capital are not required for the largest FBOs, reducing complexity for model/infrastructure implementation efforts, but FBOs can opt in for the advanced treatment
- For the U.S. branches of FBOs, the measurement period for relief on **liquidity buffer requirements has decreased from 30 days to 14 days**
- New risk management standards affect **the role of the chief risk officer (CRO), risk aggregation, and reporting capabilities across the U.S. operations**—including branches and IHC, and creation of a U.S. risk committee under the group board or the IHC board
- Liquidity risk management standards have been enhanced, including those that affect **policies, limits, and the role of the U.S. treasurer**
- FBOs that must form an IHC **must submit an implementation plan by January 1, 2015**

At a glance: scope, timeline, and operating model

Scoping considerations

The final rule for enhanced prudential standards for FBOs generally applies to institutions with total global consolidated assets of $50 billion or more, and certain provisions apply to entities with total global consolidated assets of $10 billion or more. FBOs that meet the $50 billion asset threshold and that also have $50 billion or more in U.S. non-branch assets are required to form a U.S. IHC that will be subject to enhanced prudential requirements (risk, liquidity, capital) similar to those applicable to a U.S. bank holding company (BHC). This threshold for IHC formation represents a significant change from the proposed rules, which included a much lower $10 billon threshold for U.S. non-branch assets.

Scoping and applicability

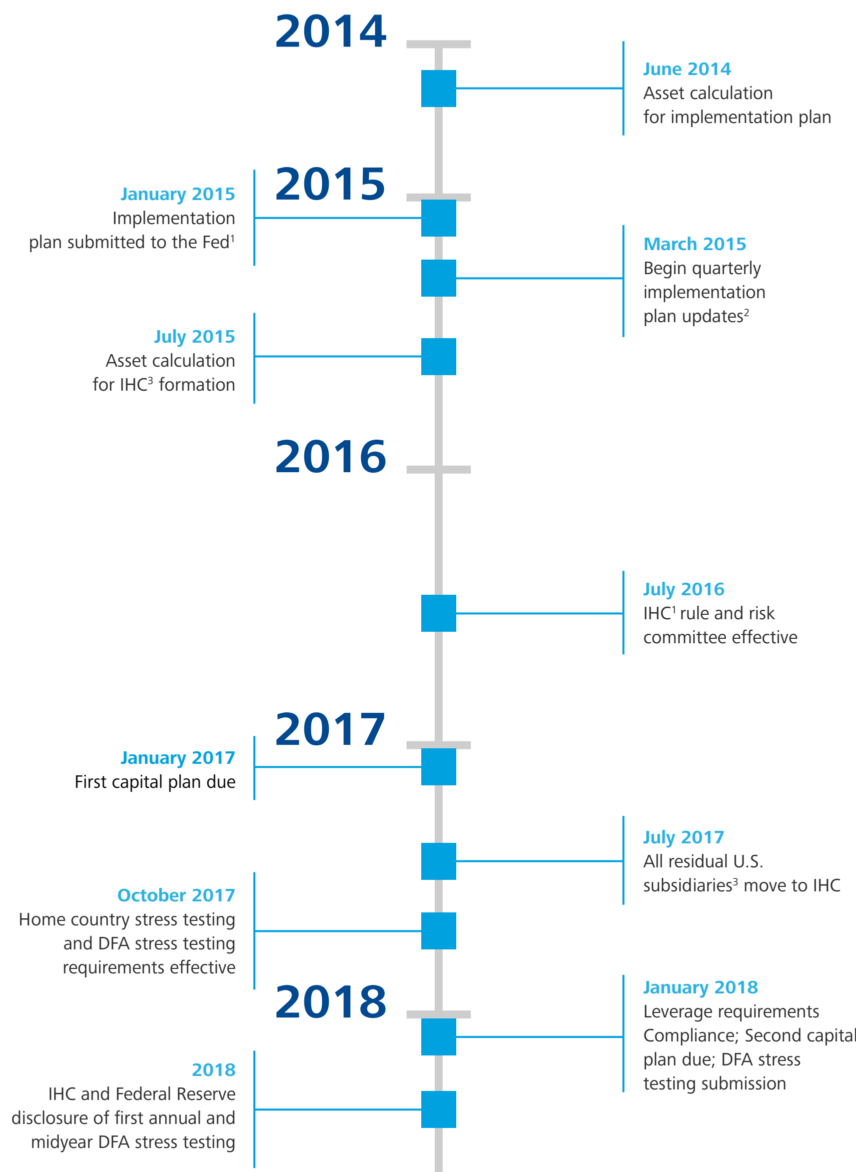
Section	Which requirements apply?	Total global consolidated assets	> $10B and < $50 B	> $50B	> $50B	> $50B
		Combined U.S. assets	< $50 B	< $50B (Branch and Non-branch)	> $50B (Branch and Non-branch)	> $50B (Non-branch only)
U.S. IHC	Creation of an intermediate holding company for all U.S. subsidiaries excluding U.S. branches governed by a board of directors and board risk committee					■
Risk management	Certify annually maintenance of a risk committee, which is responsible for U.S. operations		■	■		
	Establish a U.S. risk committee at either its IHC board of directors (if applicable) or its FBO board of directors that oversees the risk management function for its combined U.S. operations and have at least one independent director				■	■
	Appoint a U.S. chief risk officer responsible for U.S. operations (can serve as IHC CRO if applicable)				■	■
Capital and stress testing	Subject to home-country capital requirements annually; certification required if global consolidated assets >$50B that capital standards are met and are consistent with Basel standards		■	■		
	FBO must meet home-country stress test requirements in order to avoid U.S. asset maintenance and other requirements		■	■	■	■
	Subject to U.S. capital requirements for BHCs, an FBO must certify that it meets capital standards on a consolidated basis consistent with Basel capital standards				■	■
	Adopt standardized approach of the U.S. risk-based capital rules					■
	Subject to CCAR and Dodd-Frank Act Stress Test (DFAST) stress testing requirements					■
Liquidity	FBO must have liquidity risk management standards and conduct internal liquidity stress tests that will be reported to the Federal Reserve; FBOs must meet branch requirements to avoid asset maintenance			■	■	■
	Maintain a liquidity buffer in the United States for a 30-day liquidity stress test				■	■
	Report the results of a home office internal liquidity stress test (either on a consolidated basis[1] or for combined U.S. operations[2]) to the board on an annual basis			■	■	■
Debt-to-equity limits	Maintain debt-to-equity ratio limit of no more than 15-to-1, based upon Financial Stability Oversight Council (FSOC) determination that the company poses a grave threat to U.S. financial stability				■	■
regulatory reporting	Additional report to support IHC structure and capital and stress testing reporting					■

Timing considerations

FBOs that are required to form an IHC will need to comply largely with the new rules by July 1, 2016, one year later than the proposed rule. The Fed's adoption of a later effective date is meant to provide time for FBOs to implement necessary policies, processes, compliance actions, and transformations such as reorganizations and capitalization of the IHC, particularly for the largest FBOs. There is an additional transition period for those largest FBOs that need to comply with the leverage ratio, capital plan, and stress testing requirements.

What follows is an indicative timeline for key dates across FBOs (with emphasis on the largest FBOs):

Timeline



[1] Applicable to foreign banking organizations that have U.S. non-branch assets of $50 billion or more as of 6/30/14. 90 percent of non-branch assets transferred to IHC. U.S. non-branch assets are defined as equal to the sum of the consolidated assets of each top-tier U.S. subsidiary of the foreign banking organization (excluding any section 2(h)(2) company and DPC branch subsidiary, if applicable).

[2] The term "subsidiary" would be defined using the Bank Holding Company Act definition of control, such that an FBO would be required to transfer its interest in any U.S. subsidiary for which it: (i) directly or indirectly or acting through one or more other persons owned, controlled, or had power to vote 25 percent or more of any class of voting securities of the company; (ii) controlled in any manner the election of a majority of the directors or trustees of the company; or (iii) directly or indirectly exercised a controlling influence over the management or policies of the company.

[3] Quarterly implementation FRB reporting updates beginning January 2015 through January 2018.

Operating model considerations

The final rule for FBOs, particularly those with large-scale U.S. operations, will likely have broad effects across their organizations and U.S. activities. The requirement that FBOs create an IHC over their U.S. subsidiaries (excluding U.S. branch and agency networks) is designed to help the Federal Reserve provide more consistent supervision across a range of areas. As a result, FBOs may need to evaluate the impact and level of change that could be required to their governance models and infrastructures. The chart below provides a quick overview of the requirements and their impact across an FBO's IHC and U.S. branches and agencies.

Operating model impacts

Key areas of guidance	Potential operating model impacts							
	Intermediate holding company[4]				U.S. branches/agencies[5]			
	Governance	Infrastructure (including data)	Talent	Strategy	Governance	Infrastructure (including data)	Talent	Strategy
Intermediate holding company structure: Encompasses the legal entity, board, and organization structure aspects	■	■	■	■				■
Risk management: Risk management framework, risk governance, and supporting risk infrastructure	■	■	■	■	■	■	■	
Capital: U.S. Basel III capital standards and frameworks	■	■	■	■				■
Liquidity: Liquidity standards, limits, stress testing, and liquidity risk management	■	■	■	■	■	■	■	■
Stress testing: CCAR stress testing and home-country attestation/standards	■	■	■	■	■	■	■	■
Debt to equity: Debt-to-equity ratio limitation and asset-maintenance ratios		■		■		■		■
Regulatory reporting: Reporting and disclosures to the regulators	■	■	■					

4 Excludes U.S. branch and agency assets

5 Because U.S. branches/agencies are part of the foreign parent bank, they would not be included in the IHC. However, they would be subject to the activity restrictions, which are already applicable to branches/agencies as well as to certain additional liquidity measures still to be proposed.

IHC/Governance

Changes and implications in 2014

In the final rules, size continues to be a determining factor when considering the IHC and other requirements. FBOs with consolidated assets of more than $50 billion globally and U.S. non-branch/agency assets greater than $50 billion will be consolidated under an IHC. This definition of non-branch/agency assets is a clarification in the final rules. These FBOs must have placed at least 90 percent of their assets under the control of the IHC by July 1, 2016, with the remaining ownership interest in any subsidiaries to be transferred by July 1, 2017. The Fed did note that multiple IHCs could be permitted in certain circumstances, but this would require board approval.

In addition to excluding any assets associated with U.S. branches or agencies, IHCs also are to exclude special commercial companies, referred to as 2(h) 2 companies,[6] that are currently exempt under the Bank Holding Company Act and not supervised by the Fed and debt previously contracted (DPC) companies.[7]

Under its current oversight of FBOs, the Fed has relied on the home-country regulator to effectively supervise FBOs on a global consolidated basis. It has also depended on the FBO's parent to support U.S. operations under both normal and stressed conditions. The proposed IHC structure was retained in the final rules in order to have a structure, with a local board of directors, to provide oversight over non-branch activities. The management structure is likely to have a U.S.-based CEO, who would oversee the businesses and related infrastructure and controls.

The IHC, in line with recent regulatory developments, would also provide the Fed with a structure to help facilitate the resolution of part of its FBO, whether at the parent or U.S. level, by providing one top-tier U.S. legal entity to be resolved or restructured.

This IHC would be required to have a board of directors to provide a "strong," centralized corporate governance system. In addition, these rules require that a U.S. management team and board members have appropriate oversight for the IHC and U.S. subsidiaries under it. A management structure would presumably involve key business leaders and single points of contact from the control functions, internal audits, and a U.S.-based chief executive officer (CEO) who has oversight over the businesses and control functions.

[6] Section 2(h)(2) of the BHC Act allows qualifying FBOs to retain their interests in foreign commercial firms that conduct business in the United States. This statutory exception was enacted in recognition of the fact that some foreign jurisdictions do not impose a clear separation between banking and commerce.

[7] A DPC branch subsidiary is a subsidiary of a U.S. branch/agency that holds assets acquired in the ordinary course of business for the sole purpose of securing or collecting debt previously contracted in good faith by that branch or agency.

Our take

Establishing an IHC may result in a more consistent approach to risk and compliance management, governance, and supervision that cuts across business divisions. The IHC structure may also make the IHC financial, capital, and liquidity/funding picture more comparable to those at domestic banks with more than $50 billion in assets (through FRY-9C regulatory reporting for the consolidated IHC and FR Y-14 reports for capital and stress testing). This is likely to increase overall accountability among the businesses operating in the U.S. and with the IHC's U.S. management and board of directors.

Several changes may be required in the U.S. management reporting structure of FBOs to meet the new governance requirement. Key positions that would likely be considered are the CEO, CRO, chief financial officer (CFO), as well as other key senior positions. While current expectations have increasingly required a key single point of contact for each FBO, such as a chief compliance officer (CCO), an FBO that establishes an IHC would also need to have a U.S. CRO across U.S. operations and be subject to additional U.S. risk committee and capital and liquidity requirements. As a result, these large FBOs may need to reorganize their risk structures, which may require a greater clarity of roles, responsibilities, and authority.

Depending upon individual FBO legal entity structures and existing tax positioning, the change of the corporate form or the creation of the new holding company may also bring significant tax implications. Leaders at FBOs should also be prepared to examine the impact on taxes. This may prompt additional considerations of the legal structure.

To meet the final rule, the FBOs will need to hit several deadlines:

- Evaluation for formation of an IHC as of June 30, 2014, and requirement to submit an implementation plan as of January 1, 2015.
- Formation of the IHC required for at least 90 percent of the assets by July 1, 2016.
- Transfer of any remaining interests by July 1, 2017.

The costs to establish and maintain an IHC are likely to be significant because FBOs may need to establish the capabilities and infrastructure to integrate financial, operational, and legal entity information across the IHC and U.S. operations (for risk and liquidity data). The infrastructure put in place will need to support an integrated U.S. IHC view for management, regulatory, and board reporting.

Following are several additional actions that FBOs should consider as they form the IHC:

- Analyze current legal entity structure for formation of the IHC legal entity structure, considering options for multiple IHCs as appropriate.
- Understand sequencing and time frame for the formation of the IHC structure in light of other FBO initiatives that affect legal entity structure.
- Evaluate governance structure for the U.S. management team and formation of IHC board in light of parent and regional alignment issues.
- Identify key roles and accountabilities for U.S. IHC management roles particularly for new requirements around capital, liquidity, and risk management.
- Understand strategy and booking model approach that could affect the IHC structure.
- Identify implications to legal entity tracking systems that may need to be put in place for compliance going forward.
- Understand the impact of multiple scenarios throughout the IHC formation period, based on implementation plan requirements.

Risk management requirements

Changes and implications in 2014

With the final rule, requirements regarding risk committees have changed. FBOs with publicly traded stocks and total global consolidated assets of at least $10 billion, but less than $50 billion, must certify annually to the Fed that they maintain a committee of their global board of directors that oversees risk related to the U.S. operations. Considering that the proposed rules indicated that such FBOs needed a U.S. risk committee, this is a significant change. Similarly, FBOs (regardless of whether the FBO is publicly traded) with global consolidated assets greater than $50 billion and combined U.S. assets less than $50 billion, have to certify annually that they maintain a committee of their global board of directors overseeing U.S. operations.

Each large FBO is required to establish a U.S. risk committee overseeing all U.S. operations. This may be placed at the IHC, which will require its own board risk committee. Alternatively, the U.S. risk committee for the large FBO may be established at the parent. In either case, it will need to have at least one independent director. The final rule requires that a CRO be employed, and resident at, the FBO's U.S. operations and have experience managing risks of large, complex financial organizations. In the final rule, the U.S. CRO is now charged with "overseeing" risk management instead of being "directly responsible." While some specific risk management responsibilities have also been revised to become less specific in certain areas, others—such as liquidity risk management oversight—have been explicitly included.

Other notable risk committee-focused modifications are contained in the final rule, covering such issues as the relevant expertise of members of the risk committee and level of oversight. Further, the risk committee is expected to oversee the FBO's risk policies, where the preliminary rule called for oversight of risk practices. The rule also states that FBOs with total global consolidated assets of $50 billion or more, and combined U.S. assets of greater than $50 billion, comply with all the requirements regarding capital, risk management and risk committees, liquidity risk management, and capital stress testing.

This rule contains more prescriptive language regarding the risk management responsibilities of U.S. operations, including changes to the risk framework requirements that more clearly establish managerial and employee responsibility for risk management of the U.S. IHC. It also states that the U.S. IHC must take appropriate measures to implement its risk management policies, which in the proposed rules was the responsibility of the FBO.

Our take

The new rules include significant additional requirements for large FBOs that will likely send secondary effects rippling through their organizations. This may lead to changes to the aggregation, monitoring, and reporting of risks across the U.S. operations as well as enhance overall risk management, stress testing, capital, and liquidity planning. There will also likely be a need to reconfigure management information systems to enable the U.S. risk committee and U.S. CRO to meet new risk reporting requirements that focus specifically on U.S. operations, including activities within the IHC as well as branches. This may prove to be a significant change for many FBOs.

Risk capabilities aren't the only areas to address. The rules carry wider potential implications, as some of these rules apply extraterritorially, and will require careful interpretation and understanding for the parent bank. There are talent issues as well: FBOs will need to review and identify U.S.-based personnel to serve on their U.S. risk committees. Appointing qualified U.S. CROs will require careful consideration of individuals who know the business, have the right risk experience, and have experience in strengthening an FBO's risk framework.

Even if an FBO has a risk committee for its global operations, each large FBO will now have to establish one that focuses exclusively on U.S. operations. Similarly, the rules require U.S.-centric risk program evaluations no matter how robust a global program. These enhanced risk functions will likely place new emphasis on governance.

These rules reflect a deliberate attempt to strike a balance between mandating specific risk management approaches that are considered to be necessary and permitting FBOs to structure their risk management oversight in a manner that fits their individual circumstances. The U.S. risk management requirements are intended to be aligned with and leverage the FBOs' enterprise-wide risk management practices.

As a result, FBOs should plan to:

- Assess their current U.S. risk management frameworks and capabilities to determine whether they meet the requirements of the final rule.
- Develop reporting across U.S. operations for overall U.S. risk management, including stress testing and capital and liquidity planning.
- Assess the qualifications, stature, and positioning of the CRO and risk management function.
- Assess the resources required to establish and maintain this infrastructure.

Capital requirements

Changes and implications in 2014

With some exceptions, IHCs will be subject to the same capital rules as U.S. BHCs. This includes risk-based capital requirements as defined under U.S. Basel III final rules (except for the advanced approach for credit and operational risk), leverage limits, and the market risk rule (if trading requirements are met). These capital requirements are required as of July 2016—while the leverage ratio conformance period is extended until January 2018—and include:

- IHCs will need to set a minimum 4.5 percent Common Equity Tier 1 (CET1) capital ratio and 6 percent Tier 1 capital ratio with additional capital conservation buffer requirements to avoid limitations on capital distributions.
- IHCs with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures will not be subject to the U.S. advanced approaches capital rules unless the IHC opts in; however, an IHC will still be subject to:
    - U.S. Basel III supplementary leverage ratio
    - U.S. Basel III countercyclical buffer
    - Unrealized gains and losses flowing through the IHC's CET1 capital.
- IHCs with trading assets and trading liabilities that equal or exceed 10 percent of total assets or $1 billion will need to obtain separate approval from the Fed for internal market risk models and are subject to market risk rules.
- IHCs will not be required to make U.S. Pillar 3 disclosures as defined in the standardized approach if the parent FBO is subject to comparable public disclosures in its home jurisdiction.

In contrast, FBOs with less than $50 billion in U.S. non-branch assets have to certify they have met home-country capital standards that are broadly consistent with Basel capital standards, including Basel III and future amendments to this framework.

If an FBO has more than one IHC, it must satisfy the same requirements as a U.S. IHC that has $50 billion or more in total consolidated assets, even if its consolidated assets are less than $50 billion.

Our take

There is a continued trend of higher regulatory demands on the amount and quality of capital through regulation, and many large FBOs have already increased their capital levels in anticipation of these rules. No matter where each institution stands, greater awareness is indispensable—because the definition of institutions that fall under the purview of U.S. capital rules is broadening.

In adhering to the U.S. standardized approach rules, FBOs are likely to rely (to the extent possible) on the Basel infrastructure they have used or are developing for use for calculation and reporting in their home jurisdictions.

Complying with these capital rules will also bring new technical, data, talent, and management challenges:

- FBOs should assess whether their existing capabilities can meet the additional quarterly reporting. This may highlight the need to develop policies, procedures, and technical infrastructure elements—such as a central repository of risk data—to perform the capital calculations these standards require. FBOs may also need to establish new roles and responsibilities to support regulatory capital and reporting requirements.
- FBOs may need to more carefully consider the regulatory capital implications of the businesses booked with the IHC structure and to make decisions based on these results.

As more institutions fall under the definitions that result in regulatory mandates, it’s imperative for FBOs to remain aware of these changes and of the steps they should consider in response.

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 key changes and adjustments:

- The liquidity buffer for FBO U.S. branches and agencies now needs to cover funding needs for only 14 days rather than the 30 days specified in the proposed rule.
- U.S. branches and agencies no longer need to report the results of the 14-day liquidity stress test.
- The final rule further specified that any cash component of the IHC liquidity buffer cannot be held at an FBO branch or agency, or by an affiliate not controlled by the IHC. (The proposed rule only stipulated that the cash component of the liquidity buffer for an FBO could not be held at the FBO branch or agency.)
- The final rule also clarifies the definition of unencumbered assets, stating that hedges can be included in the liquidity buffer.
- 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.

Consistent with the proposed rule, the final rule will also require an FBO with greater than $50 billion in combined U.S. assets to adhere to a qualitative liquidity framework that allows leaders 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 account for cash flows arising from contractual maturities, cash flows from 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 as circumstances dictate.
- *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, event management process, monitoring requirements, and testing requirements.
- *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 denomination
    - Monitoring shifts between intraday, overnight, and term pledging of collateral
    - Tracking operational and timing requirements associated with accessing collateral at its physical location.
- *Establish and maintain capabilities for monitoring intraday liquidity risk exposure*—for a covered company 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 (14 days for FBO U.S. branches and agencies).

Our take

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.

The governance requirements of the final rules regarding liquidity should be familiar to many FBOs that have already taken steps toward implementation. Some FBOs will likely need to increase their focus on building U.S. processes to meet these local requirements at both the branch and IHC levels. FBOs should prepare for a mix of continuing and 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 for banks—one that may have a direct impact on profitability and overall business strategy.

Stress testing requirements

Changes and implications in 2014

For an FBO with an IHC, the results of the home-country stress testing will require reporting to the Fed. There appears to be an expectation that this testing be consistent with the Fed's requirements. IHCs will be subject to stress testing that is consistent with those applied to U.S. BHCs of a similar size. The compliance date has been extended to July 1, 2016. Branch and agency operations continue to have a look through to the home-country stress testing process with the potential for asset maintenance requirements.

U.S. IHCs with assets of $50 billion or more are subject to the annual supervisory and semiannual company-run stress testing requirements similar to domestic BHCs:

- If meeting the $50 billion threshold as of July 1, 2016, the IHC is required to comply with the stress testing rule requirements beginning with the stress test cycle that begins on October 1, 2017.
- Submission dates will be the same as for U.S. BHCs: For U.S. IHCs formed by July 1, 2016, with initial FR Y-14Q/M starting in September 2016, the first FR Y-14A report is due in January 2017.

Stress testing rules are currently applicable to U.S. insured depository institutions by separate rule regardless of the parent company structure or parent location. These rules are prescribed by the applicable primary federal regulator [Fed, OCC, and Federal Deposit Insurance Company (FDIC)].

There are a number of other specific implications FBOs should consider with the final new rules, including:

- Separate reporting and governance processes will need to be established for stand-alone U.S. operations.
- Since branch requirements look through to the parent organization, the resulting capital impact may not be as great as under the IHC. That means FBOs will have to consider the cost considerations between the branch and the IHC.
- Data must be produced for U.S. operations under GAAP, made more complex as a result of granular reporting requirements. Because data quality has been a challenge for many domestic institutions, it is expected to be an equally challenging issue for FBOs.
- Modeling for stress scenarios needs to be U.S.-specific with prescriptive requirements. While FBOs can leverage existing modeling capabilities, that modeling will need to be adapted to U.S. requirements based on U.S. data controlled by U.S. operations.
- Stress testing and capital planning processes are emerging as a primary focus of supervisory efforts. For IHCs, regulators will require direct reporting of data in great detail.
- Regulators expect stress testing to be embedded in everyday U.S. business decisions affecting the FBO's risk profile. As a result, new policies and procedures may need to be developed, and those already in place may need to be revised.
- Strategic planning should begin to follow a bottom-up process, in which U.S. operations feed into the foreign-based parent organization's planning, rather than vice versa. Regulators will be looking for evidence that U.S. decision-making processes are considered in the foreign parent's decision-making.
- More strenuous regulatory reporting requirements entail human capital investments with a particular focus on people with highly specific skill sets.

Our take

Like their U.S. counterparts, FBOs will need to appropriately assess the data, modeling, and governance implications of the new rules regarding stress testing and capital requirements to ensure that the local requirements can be met. This will likely need consideration of resource planning and enhanced coordination with other parts of the organization.

Stress testing requirements should be considered alongside recovery and resolution planning considerations at both the U.S. and global levels. Liquidity stress testing and the proposed liquidity coverage ratio requirements should also play a role in decision-making. For example, different business models will likely require different levels of capital and liquidity that may have different resolution implications, and this may ultimately affect business-as-usual costs.

As domestic banks may have already seen, the Fed's expectations tend to increase from one year to the next. What was acceptable one year may not be enough the next. Data quality seems to be the first issue to surface, with models that are not granular enough to meet expectations. From there, controls, process validation, and governance begin to take center stage. Across all of these issues, there is a growing emphasis on contemporaneous documentation of the decision-making processes.

As with many other rules, when it comes to data, regulatory requirements tend to increase with the size of the institution. For large FBOs, this will likely require more effort and possibly bigger investments in order to gather and analyze the relevant data.

On the way

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 FBOs) 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 decisions around single-counterparty credit limits. As early remediation requirements are tied closely to these limits from an event-triggering perspective, it is not surprising that one has delayed the other.

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. Either way, FBOs have continued opportunities to voice concerns regarding the original proposed approach to early remediation.

Counterparty requirements and implications

Changes and implications in 2014

The final rule doesn't specifically address SCCLs and will likely be re-scoped and aligned to international efforts. The Fed may determine that more analysis is required and will likely consider the results of two quantitative impact studies that are expected to be released later this year. Those studies will evaluate whether, and to what extent, specific proposed counterparty limits might affect credit availability.

Because many of this rule's requirements for capital ratios mirror those already put forth in the Basel III regulations that have been adopted by domestic banks, many FBOs with domestic subsidiaries have begun the process of becoming compliant with the proposed requirements.

Regulatory reporting requirements

Changes and implications in 2014

The Fed already has an infrastructure for analyzing banking organizations from a financial and risk perspective, and thus the same approach was proposed to apply to IHCs. Existing reports include financial statements (FR Y-9C and FR Y-11), country exposure (FFIEC 009), balance of payments (Treasury International Capital, or TIC, series), organizational structure (FR Y-10), systemic risk (FR Y-15), capital adequacy (FFIEC 101), and capital assessment and stress testing (FR Y-14 series).[8]

However, it is widely anticipated that reporting requirements will remain unchanged from the proposed rules—with the exception of the FFIEC 101, because the "advanced models" approach for capital is no longer mandatory for the largest foreign banks. It is also worth noting that the timing of these requirements will need to be aligned with the IHC implementation plan. Further implications include:

- Banking organizations that already have U.S. BHCs, or those that have experience with BHC reporting, may be well positioned to comply with these regulations when it comes to processes because they're already filing many of these reports.
- While the final rule does not require global cash flow statements for activities conducted in the U.S., IHCs that are required to file the FR Y-9LP will need to report a parent company cash flow statement.
- The final rule extends the implementation commitment deadlines—but does not reduce capital requirements for IHCs or exempt them from filing specific regulatory reports.

Our take

We expect these regulatory reporting requirements to exact a heavy toll. Once FBOs have developed an understanding of the reports, they may require more resources, an enhanced data collection and reporting infrastructure, and new processes for accurate and timely preparation. They may also need realignment of existing reporting to provide the information for U.S. reporting as well as meeting parent company needs. FBOs that have anticipated these requirements have been steadily building new governance and quality control processes, investing heavily in data infrastructure and reporting systems, and adding other resources to clear a path to implementation. This may be a further impetus to evaluating the structure of the businesses within the U.S. footprint.

What will it likely take to comply? Large investments in infrastructure, for starters. Today, many FBOs are structured so that they are aligned to their foreign parent company. In the wake of this rule, they will need to restructure themselves as stand-alone U.S. regulatory reporting entities in order to provide information that is aligned to the IHC structure.

Time will also be needed. The complexity of these reports, and the granular requirements for data within them, are likely to present big challenges to many parts of the organization, leading to an unprecedented level of disclosure of financial information in the U.S. It will simply take time to deliver on these significant demands.

[8] For a description of these reports, refer to http://www.federalreserve.gov/apps/reportforms/default.aspx.

The data imperative

FBOs operating in the United States are expected to meet similar reporting standards as U.S. BHCs. With those come expectations for regulatory reporting and internal management reporting to be legal entity aligned and U.S. aligned. In fact, the requirements for liquidity, capital, and stress testing presume a view of risk and finance data at granular levels that are transparent across U.S. operations. This requirement alone presents a unique set of challenges for the largest FBOs, as many of these firms currently operate as separate business units and have disparate data processes, architectures, and infrastructures to support a centralized risk management and reporting environment.

FBOs will also be required to comply with data management and reporting requirements outlined for U.S. institutions. And while regulators have eased overall implementation time frames from 2015 into 2016, new requirements for submission of detailed implementation plans in January 2015 signal an expectation that FBOs carefully think through their approaches to resolving complex data challenges.

Changes and implications in 2014

FBOs face a host of new challenges under the final rules. Here are a few specific implications:

- Separate management, reporting, and governance processes will need to be established as FBOs with more than $50 billion in U.S. non-branch assets create IHCs that essentially would need to report on key risk, finance, and operational data from a legal entity standpoint. This will require a cultural change as well, because for each FBO a separate IHC board must be established and operated with the independence to act in the best interests of U.S. operations and rely on reporting that focuses on U.S. businesses, risks, and processes. Reporting will need to meet the "use test." Further U.S. risk oversight and governance for the U.S. operations cover U.S. branches/agencies and require analysis to get aggregated data for a U.S. operations view.
- Data must be produced by U.S. operations under GAAP with highly detailed, regular reporting. Data quality and integrity will likely be challenges. Plus, simply isolating U.S. data may be a significant challenge to FBOs whose legacy infrastructure and business-unit-centric operating models may limit data aggregation capabilities.
- While FBOs can leverage existing model capabilities for stress testing, those models will need to be adapted to U.S. requirements based on U.S. data. Additionally, they will need to be controlled by U.S. operations, requiring additional resources. The same is true for governance, controls, and process validation, all of which must be U.S.-centric.

Our take

The bar for good data is incredibly high in the enhanced prudential standards—and the learning curve is steep, even before accounting for the need to establish U.S.-centric processes. Bank leaders cannot get started fast enough to get ahead of the curve.

Finally, FBOs should refocus their attention on analysis and implementation planning against data requirements. The additional implementation time provided by the final rule allows FBOs to reevaluate implementation plans, replacing tactical solutions with strategic enhancements in areas where compromise may have previously been accepted in order to accelerate delivery. This type of careful consideration and planning should be reflected in the detailed implementation plans submitted to regulators for review.

Ready, set…go

The Fed's final rule is expected to have a wide-ranging impact across a number of FBOs and their activities. When we evaluated the proposed rule a year ago, we said, "Ready, set …," and left it at that. Now that the rules are final—with a defined mandate and a set of deadlines in place—the watchword for FBOs is "go."

For the largest FBOs, the requirement to create an IHC is designed to help the Fed provide more consistent supervision across a range of areas like capital, liquidity, risk, and stress testing. At the same time, some FBO activities will likely be constrained. Even FBOs that do not meet the thresholds for IHC formation may have to make significant changes to their governance models and infrastructures to comply with additional risk and liquidity requirements.

Every FBO will need to evaluate these requirements carefully, analyze its current capabilities, and build implementation strategies and plans that scale to the requirements it must meet by the effective date. That task includes documentation and reporting in addition to processes and policies.

FBOs that meet the thresholds for IHC formation must also formally submit their implementation plans to the Fed by January 1, 2015. These implementation plans are expected to provide a basis for discussion between an FBO and the Fed. Expect the Fed to evaluate these implementation plans and use them as part of ongoing supervisory monitoring to understand IHC formation, financial impact, reduction of assets, and plans to achieve compliance with the risk and liquidity management requirements.

As we said in analyzing the proposed rules last year, it's a daunting to-do list. But it helps to have the finish line established once and for all. And the task begins in earnest.

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