July 2014

Regulatory brief

A publication of PwC's financial services regulatory practice

Foreign banks: US admission price rising

Overview

More than five months since the Federal Reserve (Fed) issued its final Enhanced Prudential Standards[1] (EPS) for foreign banking organizations (FBOs), a considerable number of critical questions remain unanswered despite guidance from regulators. The June 26th publication of frequently asked questions (FAQs) primarily repeated or reinforced the EPS rule's text; however, some additional clarity on key issues such as the level of detail needed for FBOs' required implementation plans was provided.[2]

We believe the key takeaway is that details matter – both in what has been explained by the Fed and what has yet to be clarified. The Fed expects a cogent and comprehensive discussion of EPS implementation by FBOs that includes a detailed assessment and a roadmap for how firms will comply with all aspects of the EPS (including structural, capital, liquidity, and risk management requirements). The implementation plan will need to reflect FBOs' planned and underway efforts to develop and implement more robust management information systems (MIS) that support risk and finance data aggregation, regulatory reporting, and stress testing.

The FAQs also indicate a strong preference for pro forma financial statements included in the implementation plans (e.g., balance sheet, income statement, and regulatory capital calculations) to be presented in the Fed's FR Y-9C reporting format. This format may be a considerable challenge for firms that are not currently required to produce these regulatory reports consistent with FR Y-9C definitions or on the basis of US GAAP, and for those firms that lack sufficient controls over regulatory reporting or have differing fiscal year-ends across subsidiaries.

On the other hand, there are still a number of details that the Fed has yet to clarify and communicate, particularly regarding the implementation of the intermediate holding company (IHC) and transfer of subsidiaries to meet the July 1, 2016 effective date, and how the creation of the IHC may impact the bank holding company's (BHC) stress testing obligations under the Fed's comprehensive capital analysis and review (CCAR).

Two additional points from the FAQs that are particularly important are:

- *Inclusion of certain entities in the IHC:* Asset Backed Commercial Paper (ABCP) conduits that are US entities are required to be part of the IHC, even if owned or managed through a branch or foreign affiliate. Since the final EPS rule's publication, firms have struggled with this requirement. We believe that this clarification clearly signals the Fed's refusal to consider excluding ABCPs and, potentially, other special purpose entities (SPEs) from the IHC where they meet requisite criteria for inclusion. It is critical that FBOs carefully re-assess their assumptions regarding what is excluded from the IHC.

- *Stress testing requirements when an existing BHC becomes the IHC:* For firms which are creating an IHC which is not the current US BHC (or there currently is no BHC), the first IHC capital plans will be due in early 2017, and full CCAR and Dodd Frank Act Stress Testing (DFAST) requirements will take effect in early 2018.[3] If a firm elects to designate an existing US BHC which is currently subject to the capital plan rule (e.g., CCAR) as the IHC, existing stress testing requirements remain applicable and new legal entities transferred to the IHC will be subject to the capital plan rule immediately upon transfer (i.e., no later than July 1, 2016). This could significantly accelerate the MIS and reporting burdens for impacted firms, while further complicating the decision between creating a new IHC versus converting an existing US BHC.

This **Regulatory Brief** analyzes the FAQs, incorporating approaches taken by FBOs across the industry, and suggests actions that firms should be taking now.

FAQs – Key points and industry approaches

The Fed expects detailed implementation plans

The FAQs eliminated much of the confusion that existed regarding the content, level of detail, and format of the implementation plan.

Plan content

The plan's content must comprehensively detail the firm's current state of compliance with EPS requirements, and moreover assess the FBO's existing shortfalls and planned actions to remediate these shortfalls. Therefore, a successful plan will include a roadmap for complying with all EPS requirements across the IHC and consolidated US operations (if applicable), including timing, dependencies, and implementation risks and related mitigants. Further, the plan should include MIS efforts to support compliance with the EPS requirements.

Plan detail

The plan should include sufficient detail for the Fed to assess its reasonableness and achievability. While the FAQs do not specify the length of the document, they do identify the following necessary components:

- Proposals for implementing MIS that can aggregate risk metrics across combined US operations
- Plans to develop CCAR forecasting capabilities to produce reliable estimates of future capital needs
- Stress testing regulatory reports (i.e., forms FR Y-14A, Q, and M)
- Calculation of consolidated current capital positions

Our observation of similar submissions (e.g., CCAR and resolution plans) indicate that once the plans are submitted, the Fed's examination teams will request greater supporting detail for them. Accordingly, some FBOs are taking a bottom-up approach to building their implementation plans and developing detailed project plans for pertinent EPS requirements. Firms that had hoped and prepared to provide only high-level analysis have more work to do in this area.

Plan format – Pro forma financial statements

The FAQs reiterate the Fed's strong preference for FBOs to present three years of prospective quarterly financial statements using the FR Y-9C format. FBOs that had already been planning to produce their income statement, balance sheet, and regulatory capital schedules using this format have been facing the following two major challenges:

- Identifying, mapping, and sourcing financial information for US subsidiaries (e.g., broker-dealers and leasing entities) that currently do not produce FR Y-9C, call reports, or similar regulatory reports
- Eliminating inter-US entity transactions and recognizing transactions between non-US affiliates and prospective IHC entities in order to prepare consolidated US GAAP financials for the IHC

We have also seen that FBOs that lack sufficient controls over regulatory reporting and have differing fiscal year-ends across subsidiaries are facing more difficulty than their peers in preparing these statements.

Inclusion of ABCP conduits and other SPEs

The FAQs clarify that ABCP conduits incorporated in the US would be considered "US subsidiaries" of the parent FBO and included within the IHC, even if these vehicles are owned or managed by a branch or a foreign affiliate.

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[1] See PwC's *First take: Enhanced prudential standards* (February 19, 2014).

[2] FBOs with $50 billion or more in non-branch US assets are required to establish IHCs in the US by July 1, 2016 and submit plans for implementing the IHC by January 1, 2015.

[3] The Fed recently issued proposed amendments to the capital plan and stress testing rules that include a change to the CCAR and DFAST submission dates for large banking organizations from January 5th to April 5th of each year, effective in 2016. See PwC's *First take: Capital plan rule* (June 13, 2014).

Based on this heightened expectation, we believe FBOs should carefully re-assess all of their US entities for potential inclusion within the IHC, especially interests in other SPEs. FBOs have so far been focused on considering the inclusion of entities in the IHC based on the entity's business performance/strategy compared to its capital/compliance costs.

Stress testing transition provisions

In addition to increasing efforts to satisfy heightened Fed stress testing expectations,[4] FBOs have to traverse some difficult regulatory terrain in the attempt to capture tax, liquidity, and funding benefits. The designation of certain entities as the IHC, and the timeline for asset movement, may result in significantly accelerated timing for complying with US risk-based capital rules, regulatory reporting, and CCAR.

The EPS provides a transitional period for IHCs that have not previously been a US BHC. These IHCs need not submit their first capital plans until early 2017 when they will be subject to stress testing based on scenarios provided by the Fed. These initial stress testing requirements will be similar to those under the Capital Plan Review (CapPR) that eleven US banks were subject to in 2012 and 2013, rather than the CCAR and DFAST currently required for US BHCs. After their initial submissions, starting in early 2018, these IHCs will be required to participate in CCAR and DFAST.

How much capital is enough?

The FAQs note that implementation plans must include provisions for the accretion, transfer, or raising of capital as necessary to meet US risk-based capital requirements. While calculating stressed capital levels is not required by the final EPS rule, we believe that firms should have a reasonable understanding of the performance of their portfolios under adverse scenarios (and whether capital is sufficient) prior to July 1, 2016. At this juncture we are aware of a number of FBOs that have begun to analyze anticipated capital needs for the IHC by utilizing peer comparisons to roughly estimate capital needs under CCAR and DFAST. These FBOs are using DFAST disclosures (e.g., credit losses by loan type, charges for other than temporary impairment (OTTI), and pre-provision net revenue ((PPNR)) to estimate a range of IHC capital requirements and to attribute potential capital costs to their lines of business.[5]

[4] See PwC's *A Closer Look, Stress testing: A look into the Fed's black box* (April 2014).

[5] See PwC's Regulatory Brief, *Stress testing: Midterm results improved, but it's all about the final* (September 2013).

For firms which will need to implement the Market Risk Rule at the IHC, the FAQs include a reminder that model approvals are an iterative process between the supervisor and the organization which often requires lead time.[6] To that end, we believe that FBOs should be fast-tracking the development/refinement of market risk models, and subjecting these models to a robust validation process so that they can be submitted for approval well in advance of the July 1, 2016 compliance date. While some firms may have previously received Fed approval for their market risk models, application of these models to new portfolios will need to be separately reviewed and approved by the Fed. Thus, FBOs should engage the Fed's on-site teams to align expectations on the number and types of market risk models that will need to be approved.

Risk management

The Fed continues to underscore the importance of risk management and describes in the FAQs additional details to be included in the implementation plans regarding the nature and frequency of the US risk committee's interaction with the global board and global operations. Furthermore, a description of how the firm will avoid potential conflicts of interest between US and global entities should be included in the implementation plan. As we have been advising (and is implied within the EPS rule), FBOs need to consider structuring their global risk management around a single US risk management framework to accommodate regulatory expectations.

The FAQs also reiterate that the US CRO must primarily focus on risk management over the FBO's combined US operations and the US CRO's risk remediation responsibilities should not be delegated to, or be dependent on, other FBO employees. For firms considering multiple CROs at the legal entity level, the escalation and reporting mechanism for the risk framework must ensure that the US CRO retains ultimate responsibility for risk management over the consolidated US operations.

Liquidity

The FAQs reiterate the requirement to describe the size and composition of the liquidity buffer in IHC implementation plans. We believe that the buffer must be calculated based on current rather than future net cash outflows. FBOs should not calculate their liquidity buffer based on estimated net stressed cash outflows during the forward period (i.e., December 31, 2014 to December 31, 2017) similar to what is done in pro-forma

[6] The Fed's Regulation Q requires a firm with trading assets of over $1 billion to use internal risk models to calculate its trading portfolios' risk-weighted assets.

financial statements but, rather, FBOs should calculate the IHC's liquidity buffer based on current net stressed cash outflows of entities that will be included in the IHC structure.

Liquidity buffer composition

FBOs must also describe in their implementation plans the composition of liquid assets that will comprise the buffer and how those assets meet the EPS criteria. This is particularly important as, under the IHC regime, cash and US government securities (e.g., Treasuries and GSE debt) are considered liquid assets without exception, while other assets such as those identified within the LCR proposal would be considered liquid only if they meet certain criteria (e.g., low market and credit risk, active secondary market, and a history of being purchased by investors during stressed market conditions). Accordingly, implementation plans that include assets of this latter group in the IHC liquidity buffer should also have analysis supporting their inclusion.

Liquidity buffer within the IHC structure

The FAQs also address the placement of the liquidity buffer and include a reminder that FBOs must consider Regulation W limitations that may apply to the IHC (depending on its structure) and the potential to limit transfers of buffer assets or cash flows between entities within the IHC. For example, liquid assets located in a subsidiary bank will count as part of the parent IHC's liquidity buffer; however, there may be limitations to how excess liquidity can be transferred to other parts of the IHC structure. Alternatively, liquid assets held at the IHC level may be shifted without concern of Regulation W. Therefore, FBOs should consider the placement of the liquidity buffer and the need for flexibility depending on the complexity of their IHC structure.

Independent review

Finally, the FAQs expand upon internal controls and the independent review process requirements related to liquidity. With respect to internal controls, the Fed does not require that the risk management function set liquidity risk limits, but rather that the CRO opine on the suitability of liquidity risk limits. FBOs should ensure independent review of the appropriateness of limits vis-à-vis the IHC's liquidity risk appetite statement. Based on the characteristics of the independent review functions offered in the FAQs, the review function would be best placed within risk management or a similar enterprise-wide function, as opposed to say audit, given the expertise needed for liquidity risk monitoring and the CRO's oversight, review, and approval requirements. This placement also conforms to current practices at many BHCs that comply with similar requirements.

What should FBOs be doing now?

In addition to considering our analysis and the industry approaches set forth above, FBOs should be considering the following points as they work toward EPS implementation:

- *Establish the governance framework for US operations as soon as practically possible.* FBOs should promptly designate a CRO and actively engage the board and senior management in overseeing EPS implementation efforts, e.g., around governance, IHC structure, and gap remediation.
- *Finalize the IHC structure.* At this point FBOs should have the design for their IHC structure nearly finalized, as this is critically important to the development of the implementation plans due on January 1, 2015, and the broader EPS compliance effort. Activities such as plans for integrating, moving, or winding down subsidiaries, and strategic plans for revising asset and business activities across IHC entities should be on-going. FBOs should also have plans in place to address the tax, regulatory, financial (e.g., capital and funding), and business impacts of these changes.
- *Finalize gap remediation.* In light of significant gaps which have already been identified by many FBOs (between their current state and regulatory expectations), FBOs must be designing and planning for remedial actions around risk and finance data, MIS, regulatory reporting, capital planning, CCAR, liquidity, risk management, and corporate governance requirements. We believe firms must have comprehensive project plans expanding upon the efforts described in their implementation plans when submitted. The FAQs make clear that on-site supervisory teams will be using the more detailed project plans to understand the extent of remediation efforts and will be monitoring progress against these plans to determine whether the FBO will meet the requirements by July 1, 2016. It is our view that successful remediation planning includes prioritizing activities based on the required level of effort and dependencies between EPS requirements. For example, addressing gaps in risk and finance data aggregation (a component of pro forma financial statement due on January 1, 2015) could take precedence over others issues, given its implications for regulatory reporting (e.g., FR Y-9C and FR Y-14s).
- *Regularly communicate with regulators and peers.* FBOs need to effectively communicate with the Fed and with their local exam teams. Given the evolving nature of supervisory expectations and interpretations, FBOs should regularly utilize the Fed's EPS mailbox for guidance and direction, and maintain dialogue with other FBOs implementing EPS and with US firms subject to EPS.

Additional information

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