

Beyond capital

What institutions that may be regulated as bank holding companies should start working on today



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The heart of the matter

For BHCs and FHCs, deliberate preparation and a focus on cultural change is key

During the financial crisis, a number of major nonbank financial firms have become bank or financial holding companies (BHCs or FHCs). For these companies, the transformation yields the direct benefits of enhanced access to Treasury and Federal Reserve (Fed) financial support or liquidity programs and the indirect benefit of enhanced market standing by being subject to consolidated supervision by the Fed. More recently, under the Obama Administration's Financial Regulatory Reform proposal ("A New Foundation"), a number of companies face the possibility of mandatory BHC/FHC status, arising from their ownership of thrifts, industrial banks, credit card banks, or trust companies. Even some companies that do not own an insured depository institution face this possible change if they are designated as systemically important financial institutions, so-called Tier 1 FHCs.

Regardless of whether BHC/FHC status is voluntary or mandatory, institutions can expect a "brave new world" of consolidated supervision and regulation. For most new BHCs/FHCs, this regulatory scrutiny represents a significant change, and the scope of the expectations can be a culture shock. While there are many benefits of becoming a BHC or FHC, the new regulatory demands present significant challenges, requiring management to make substantial changes in the way it conducts business.

But new BHCs/FHCs cannot afford a steep learning curve. The penalties for noncompliance are stiff. Regulators can impose a variety of informal or formal enforcement remedies that can restrict an organization's growth and halt strategic plans until control structures and risk management programs meet agency expectations. Such disruptions can negatively impact key revenue streams. Moreover, remediation efforts can be complex and competitively damaging, potentially embedding high remediation costs in processes long after the problems are corrected. Regulators may also require organizations to increase capital, curtail lending, or sell assets. And FHCs whose depository institution subsidiaries are not rated as "well managed" may lose FHC status, preventing them from continuing to own insurance, securities, or other financial affiliates.

Key definitions:

- A bank holding company (BHC) is a company that owns or controls a "bank," which is generally defined to include an FDIC-insured bank. A BHC and its nonbanking subsidiaries may engage only in certain financial activities deemed closely related to banking as of 1999.
- A financial holding company (FHC) is a BHC that may engage in a broader range of activities considered to be financial in nature, including insurance underwriting, securities dealing and underwriting, financial and investment advisory services, merchant banking, and all activities permissible for a BHC. An FHC's bank subsidiaries must be "well capitalized" and "well managed" in accordance with regulatory definitions. Additionally, FHCs are subject to an enhanced framework of supervision to assess how nonbanking business risks affect the safety and soundness of bank subsidiaries.

How can new BHCs and FHCs successfully manage this transition?

The answer is two-fold. First, be prepared. Developing a proactive plan to manage the key components of regulatory expectations for safety and soundness sends regulators a message that your organization is ready for oversight and is prepared to enter the normal supervisory cycle, thus reducing the risk of remedial actions. A proactive plan avoids the most common pitfall of becoming a new BHC—not appropriately preparing to be regulated on a consolidated basis. Second, keep in mind that the newly developed risk framework must be woven into the company’s cultural fabric in order to maintain the long-term safety and soundness of the organization and promote compliance as a customary course of business.

An in-depth discussion

Five areas of focus for successful regulatory planning

The mission of the Fed's Divisions of Supervision and Regulation is to ensure the safe and sound operation of BHCs/FHCs so they can serve as a source of strength to their insured depository institution subsidiaries. As such, BHCs, FHCs, and their subsidiaries are subject to more comprehensive supervision and a tighter reign on risk taking as compared to other financial institutions. These companies must also prepare for annual Fed inspections that focus on their financial condition, systems for monitoring and controlling financial and operational risk, and regulatory compliance.

Companies must be able to demonstrate to examiners that they have an understanding of the regulatory requirements and have a plan in place to address them.

While mastery of a complex regulatory system presents a hurdle for new BHCs/FHCs, the path becomes clearer and more manageable when broken down into five key areas: corporate governance, risk management, financial condition, regulatory compliance, and change management.

Corporate governance—why getting it right may not be enough

From a regulator's perspective, safe and sound operation cannot be achieved without corporate governance that outlines a clear and concise organizational structure, with board and committee oversight that is formalized and documented. Corporate governance must support and complement the company's strategic and tactical decision-making processes and risk management activities based on its business profile.

It's important that organizations not minimize the requirement to document their corporate governance structure. In the absence of documentation, even companies that establish and practice appropriate corporate governance do not meet regulators' expectations, which could be a costly mistake.

How to proceed

Achieving the appropriate corporate governance structure can't happen without first undergoing an organizational change. To begin, identify the board members and senior management who will formally oversee the organization's strategic direction and ensure appropriate documentation of roles and responsibilities as well as board and committee meetings.

Next, design, charter, and formalize a board member and senior management committee structure to oversee the operations of the key business lines. Once the high-level structure is in place and documented, the management committees should oversee documentation of corporate policies and procedures and institute an annual review process to reevaluate and update the procedures. In addition, the management committees should develop key reporting metrics and packages based on business lines and risks and present the findings to the committees and the board.

Risk management—new rules, a new playing field

Before becoming BHCs/FHCs, companies may have had the latitude to manage risks as they deemed appropriate. Now, for the first time, they must comply with a set of well-defined regulatory risk management rules.

Among the items regulators closely examine are inherent levels of credit, market, liquidity, operations, compliance, legal, and reputational risks.

Figure 1: Example of how examiners will gauge risk



Also under scrutiny is the quality of associated risk management practices, related policies and procedures, and whether independent risk functions exist, such as loan review and internal audit. Regulators will then determine the residual levels of risk and the likely trend of risks facing the institution over the next 12 months.

Operating under these new risk management expectations challenges many new BHCs/FHCs. It may require letting go of long-standing, deeply ingrained risk management practices and adopting the vernacular of the regulators. In short, BHCs must shed any prior assumptions and ensure they are judging, with an impartial eye, risk management practices as a regulator would, incorporating the necessary changes into the organization to meet these new expectations.

For example, loan officers at many nonbank lending institutions operate under more autonomous credit authorization practices and lending limits than they would be subject to under Fed supervision. In this regard, officers may not currently need a committee authorization or peer review to advance funds. Instituting a stricter standard and review process can slow activities and cause frustration within the lending lines. However, examiners expect tight controls on lending, clear policies and procedures for advancing funds, and thorough reporting and tracking of any lending policy deviations. Additionally, the loan review function will, among other things, apply a risk rating to a credit that supersedes a loan officer's rating and may require more reserve and additional ongoing monitoring of the credit facility. Independent review functions are expected to be "drivers of change" within the organization, and their findings, such as downgrading credits, could cause lending policy changes in the front office and require loan officers to change their practices. This is something that most nonbank lending institutions, or lightly regulated lenders, are not accustomed to, and can have a negative effect on employees.

How to proceed

To build an effective risk management program that meets or exceeds regulatory expectations, start by performing a high-level risk assessment that covers strategic, credit, market, liquidity, operations, legal, and reputational risk. The assessment should address the following questions: What is my inherent level of risk? What are my business activities, and how are they viewed by regulators? Do the programs I have in place to control these risks meet regulatory expectations and industry standards? If not, determine the gaps that exist and create a well-documented plan to fill those gaps.

Financial condition—prepare for a dialogue

BHCs/FHCs are subject to strict capital rules that may require maintenance of higher, or possibly lower, levels of capital than previously required. One way regulators will gauge a company's level of capital, earnings, and asset quality is by benchmarking them against banks of similar size and complexity. Regulators also use the CAMELS schema (capital, assets, management, earnings, liquidity, and sensitivity to market risk) to evaluate a bank's financial health and its ability to manage risk.

But formalized ratings scales are not the Fed's only method of evaluating financial condition. Management at new BHCs/FHCs may be surprised to learn that along with complying with capital rules, they must also have a dialogue with government officials who play a significant role in determining the final regulatory view of their institution's safety and soundness. These discussions can impact the amount of capital required.

Prior to these conversations, management should be prepared to substantiate that the institution's capital levels adequately support its current risk profile. Management should also be able to demonstrate that the strength and quality of its strategic planning, corporate governance and risk management practices, compliance programs, and financial performance justify the current capital levels and any planned growth. Regulators will expect to have this dialogue with the management team on an ongoing basis. In fact, it will be the underlying theme of most conversations with the examiners. In addition, regulators will want to know, in real time, about planned changes in the company's profile, such as mergers or acquisitions, including the impact on capital levels or other perceived risks and how the management team is addressing them. It is important to maintain and lead the dialogue on this topic to cultivate the regulators' confidence in the management team and the organization as a whole.

This is a marked shift in operating procedure for new BHCs/FHCs that are accustomed to determining their own capital requirements and factoring in the impact it will have on earnings. Undoubtedly, this change requires a delicate balancing act as management must comply with regulatory capital requirements while also answering to shareholders.

How to proceed

Financial management takes on a different perspective through the eyes of regulators who seek to ensure safety and soundness through appropriate capital levels. BHCs/FHCs must embrace this perspective as well, striving to incorporate these same parameters into the financial management processes through appropriate asset quality, liquidity, and supporting capital levels.

Be prepared to discuss this topic with regulators and present a plan to meet the necessary minimum capital requirements. Benchmarking is a good way to prepare. Leverage the available public information to help determine how your company compares to peer institutions.

Additionally, develop and formalize a three- to five-year strategic plan and supporting capital plan that projects earnings, dividends, and adequate risk-based capital ratios on an annual basis in accordance with regulatory expectations. Organizations that do not have adequate capital levels must be prepared to present a plan that specifically maps out how they will achieve and maintain the required levels.

Regulatory compliance—managing expansive legal requirements

New BHCs/FHCs must comply with a multiplicity of state and federal banking regulations, including Regulation W (intercompany transaction rules), Regulation Y (activities, acquisitions, and governance), Anti-Tying, Management Interlocks, Bank Secrecy Act/Anti-Money Laundering, Office of Foreign Assets Control, and USA Patriot Act, to name just a few. Although the regulatory requirements are specific, it is up to each organization to determine the method for implementing a sustainable process or program that achieves compliance with the laws and regulations.

For example, Bank Secrecy Act regulations require an adequate system of internal control to identify suspicious activity and file suspicious activity reports in a timely manner; however, the rules do not specifically communicate how to implement a program to comply with the requirement. While guidance accompanies some regulations, in most instances this still only sets forth expectations. Compliance officers and senior management are expected to gather information regarding industry practices and regulatory expectations and then develop a compliance process or program that is commensurate with their institution's business profile and complexity, and that can withstand audit and regulatory scrutiny.

How to proceed

Despite the complex and voluminous regulatory environment, companies must show preparedness. Start by creating a plan to identify key regulatory compliance requirements, identify gaps, and implement processes to close those gaps. Perform an inventory of applicable state and federal laws and regulations, including those that cover safety and soundness as well as consumer compliance. Include regulatory guidance and industry standards in the inventory, as well as hot-button issues such as affiliate transactions and anti-money laundering. Because of the intricacy of banking regulations, consider bringing in a specialist with industry knowledge and experience.

Start early to plan for regulatory reporting requirements that take effect the quarter after the company achieves holding company status. Similar to preparations for laws and regulations, conduct an inventory of the applicable reporting requirements and work toward designing a reporting system that is sustainable to meet the requirements on an ongoing basis. One of the key challenges in developing accurate regulatory reporting is that the specific information needed to complete the reports may require significant collection or mapping of data, and the time constraints can present added pressure.

Regulatory reporting requirements are complex and are intended not only to present an institution's financial condition, but also to provide more detailed information to be used by examiners and other stakeholders. Specific requirements will include consolidated financial condition and capital reporting on a quarterly basis on form FR Y-9C. Examples of other reporting requirements specific to BHCs/FHCs include reports for material domestic or foreign nonbank subsidiaries, the FR Y-11/11S and FR 2314, respectively; equity investments in nonfinancial companies on form FR Y-12; and changes in organizational structure on form FR Y-10.

A compliant organization—sustaining change through people

Beyond maintaining capital, writing policies and procedures, and meeting supervisory expectations, risk and compliance requires applying key principles of change management and organizational change to create long-term rewards.

Companies must view regulatory compliance as a common and standard leading practice that they should adopt at all levels of the organization. This means embedding new processes, roles, and responsibilities into employees' everyday business activities and ensuring those activities link to the overall regulatory goals.

How to proceed

First create a sense of transparency and accountability within the organization with a robust communication plan that helps spread awareness of the need for change. Next, assess the current processes, roles, and skills within the organization, and design new roles and responsibilities for the desired regulatory state to develop a roadmap that will create and sustain change. The roadmap should include ongoing awareness and communication activities, job redesign, training, performance management, metrics, and measures of success—all of which are components of changing the long-term business culture.

What this means for your business

Regulatory success hinges on readiness

Our research indicates that most new BHCs/FHCs experience difficulties adapting to heightened regulatory expectations. Although this is not surprising given the complexity of the regulatory system, companies cannot afford the regulatory criticism or enforcement actions that could result from deficiencies.

Putting the pieces of the puzzle together need not be daunting. With the right approach, new BHCs and FHCs can create an effective, sustainable governance and risk management program. It takes a cultural shift, a proactive mindset, and focused planning, but in the end, your organization will be well-positioned to take advantage of strategic opportunities as a safe and sound banking institution. Indeed, when it comes to BHC/FHC requirements, there is no time to wait. A prepared organization sends a signal to examiners that it is ready to operate in the highly regulated banking industry.

Contact information

As the financial services industry and its regulatory structure have transformed, PricewaterhouseCoopers has assisted clients in navigating the complexities of the new environment. Our professionals help companies integrate acquired businesses and people into their bank holding company structures, as well as provide advice as clients evaluate the strategic opportunities and assess the impact of becoming bank holding companies. To learn more, please contact:

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