

Regulatory brief

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Foreign banks: Hope is not a strategy – Time to act

Overview

In December 2012, the Federal Reserve published a notice of proposed rulemaking (NPR) describing how the Enhanced Prudential Standards (EPS) under the Dodd-Frank Act would be applied to foreign banking organizations (FBOs). The NPR is the most significant regulatory development for FBOs since the passage of the International Banking Act of 1978 which introduced the principle of national treatment for FBOs.

The NPR compels larger FBOs with material US operations to establish an Intermediate Holding Company (IHC) for virtually all of their US subsidiaries, essentially ending the Federal Reserve's willingness to rely solely on the parent company for financial support of an FBO's US operations. US capital, liquidity and other regulatory mandates will have to be met in the US. US branches and agencies of FBOs would remain outside of the IHC structure but would nevertheless have to comply with enhanced liquidity requirements.

While some adjustments to the NPR are possible before the rule is finalized, we believe substantial change is unlikely, particularly with regard to the requirements related to establishing an IHC and those related to capital and liquidity. Governor Daniel Tarullo – who first unveiled the proposal in a speech last year – continues to signal strong support for the core tenets of the proposal despite foreign governments, trade associations and individual institutions registering their deep objections. We expect the final EPS rule to be issued by the end of this year, which would apply to both US and FBO institutions.¹

We have found that the biggest immediate challenge FBOs face in conforming to the NPR is in developing the capability to aggregate risk data across multiple platforms. We are seeing that the more institutions delay in making the necessary upgrades, the fewer (and significantly less flexible) options they have, especially with the expected July 2015 effective date now less than two years away.

With similar data aggregation expectations arising in other regulatory areas, such as stress testing and resolution planning, FBOs now have the opportunity to gain efficiencies by undertaking multiple data aggregation efforts simultaneously.

As a reality check, the top 30 US banks have been working to meet their CCAR obligations since 2009. Many still have not finished. The hard truth is that effective data aggregation takes two to three years.

¹ See PwC *Financial Services Regulatory Brief, US regulatory outlook: second half of 2013 – Final enhanced prudential standards and Basel III rules* (June 2013).

This **Financial Services Regulatory Brief** provides our view of (a) the actions institutions should be taking before the NPR is finalized, and (b) synergies that may exist between conforming to the EPS and other global or US regulatory initiatives.

Actions to take before the final rule

It is clear that expectations for data production, storage, transformation and reporting will be considerably higher upon finalization of the NPR. Moreover, the recent Principles for Effective Risk Data Aggregation and Risk Reporting² (DARR) from the Basel Committee of Banking Supervision (BCBS) presses banking institutions, particularly those designated as systemically important (G-SIBS), to significantly enhance risk analysis and reporting, with a strong emphasis on data segmentation by legal entity.

US Secretary of the Treasury Jacob Lew added to this concept in his May 2013 testimony before Congress on the priorities of the Financial Stability Oversight Council (Council), stating that the Council is focused on data resources and analytics among its major initiatives:

The Council continues to recommend that improvement in data standards should be a high priority for financial firms as part of their risk management process and for the regulatory community – not just in the United States, but globally. The Council recommends that the Office of Financial Research continue to work with the Council's member agencies to promote data standards for identification of legal entities, financial products, and transactions, and to improve access to standardized, aggregate data by the regulators. The Council also recommends that cross-border exchange of supervisory data among supervisors, regulators, and financial stability authorities continues to be facilitated in a manner that safeguards the confidentiality and privacy of such information.

This quest for a single source of enterprise wide risk data, and the capabilities to drill down by type of risk (e.g., credit or liquidity) and by legal entity, will be challenging for most firms. Achieving this goal will require significant enhancements in data production, storage, transformation and reporting to ensure comprehensiveness, timeliness and precision.

In addition, DARR suggests that limitations on these capabilities at firms should trigger supervisory actions. It is our view that given the high correlation between achieving readiness for the EPS rule and DARR, firms should consider addressing both through a coordinated approach. As with any new rule or guidance, we believe it is critical that the firm understand the current state of the firm's data management and reporting ecosystem, in this case by leveraging the regulator-mandated DARR self-assessment and by completing a comprehensive remediation plan. Firms should consider whether a less than two-year lead time for conformance is sufficient given the required changes to data production, storage, transformation and reporting necessary by the July 2015 effective date. Of note, many firms' comments on the NPR stated that a longer transition period is necessary for such extensive data infrastructure enhancements.

We also believe that the inability to produce, transform and report risk and financial information to meet the enhanced regulatory demands will result in a much more intrusive supervisory approach including restrictions on business activities, additional capital requirements and larger liquidity buffers. Thus, firms should start to mitigate these impacts now.

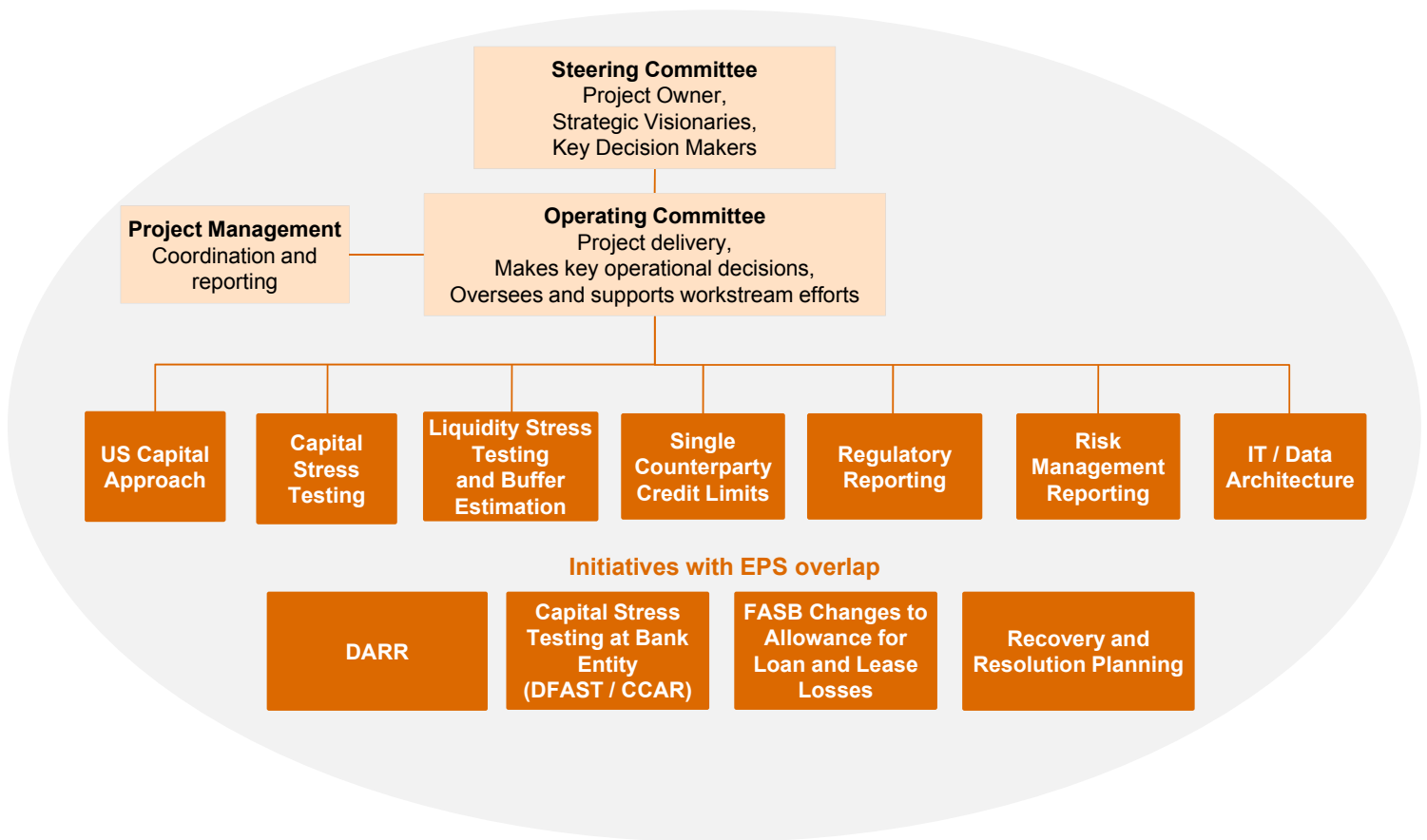
Project governance

As with any large scale multi-faceted project, the efforts to assess and address infrastructure challenges should be supported by an appropriate project governance structure. Effective execution of this type of transformation should be directed by a steering committee, and managed by an operating committee supported by a project management office.

Firms need to establish a robust project governance structure, including identification of key stakeholders and sponsors, determination of decision-making authorities, establishment of objectives, and communication and coordination processes. Our experience with projects of this complexity and impact suggests it is critical that the project governance structure allow for timely and efficient decision making. The structure should be inclusive and allow for a coordinated approach amongst the steering committee, operating committee, project management team, and workstream leads for the critical areas.

² <http://www.bis.org/publ/bcbs239.htm>.

A representative project governance structure is depicted in the following graphic:



The above structure describes a fairly broad representation of activities, which is indicative of the sweeping nature of the NPR. Additionally, there are a number of other recently released Dodd Frank and supervisory initiatives (such as capital stress testing at the bank entity), which may impact firms' strategic response to the NPR due to overlap. It is critical that firms consider these additional requirements to develop solutions through an integrated approach.

Gap analysis and identification of capabilities that can be leveraged

This section describes an approach firms can apply to identify and prepare for the enhanced data production, storage, transformation and reporting requirements. The focus is on understanding current capabilities, identifying gaps between current capabilities and EPS expectations, and creating action plans to meet the expectations with an emphasis on those capabilities that can be leveraged across expectations.

The gap analysis should begin with a determination of the data capabilities required to align to the EPS. These capabilities will vary for firms, especially depending upon the range of possible solutions or structures considered for the firm's future state.

Firms should also focus their efforts on identifying existing approaches, methodologies and systems that can be leveraged to meet the broader EPS requirements. For example, if the firm has a depository institution within the span of its US operations, the approaches, methodologies and systems for capital and stress testing may be able to be leveraged for the FBO reporting requirements.

A basic framework for understanding the data requirements is depicted in the following table:

Data production	<ul style="list-style-type: none"> • Determination of current state versus regulatory expectations • Considerations should include: <ul style="list-style-type: none"> – Availability – Format – Frequency – Data taxonomy/architecture – Source – Naming conventions/consistency – Mapping – Data characteristics 	Data transformation	<ul style="list-style-type: none"> • Determination of current state versus regulatory expectations • Approach/methodology for data transformation • Aggregation capabilities across legal entities, risk silos and business lines • Accuracy and precision expectations for data combination
Data storage	<ul style="list-style-type: none"> • Determination of current state versus regulatory expectations • Large data sets and volume • Advanced analytics • Load speed • Queries • Memory processing • Adaptability • Warehousing capabilities 	Data reporting	<ul style="list-style-type: none"> • Determination of current state versus regulatory expectations • Systems supporting regulatory and risk reporting • Flexible segmentation of data by legal entity, IHC, and branch • Limited manual intervention • Accuracy and precision

While the EPS requirements are very broad, we believe that focusing on the following requirements will identify the bulk of the data, methodology, and system needs:

- Capital planning and stress testing
- Liquidity management and stress testing
- Single counterparty credit exposure aggregation
- Regulatory reporting

Although firms could also include other EPS requirements, firms will need to consider the trade-off between precision and level of effort when scoping the work they plan to do.

The following chart details some analysis of data production, storage, transformation and reporting capabilities that should be undertaken for each of these four EPS requirements:

EPS element	Key infrastructure considerations
Capital planning and stress testing	<ul style="list-style-type: none"> • Macro and idiosyncratic capital stress testing scenario generation process • Loss forecasting models for credit risk and operational risk • Pre-provision net revenue forecasting model • Linkage of macro scenarios to losses and business drivers • Basel III pro-forma estimation • Regulatory capital calculation under Basel III, including Advanced Approaches and Market Risk rule, as appropriate • Data aggregation and consolidation • Model documentation and validation in line with FRB Supervision and Regulation Letter 11-17 • Documented processes and controls across components of Comprehensive Capital Analysis and Review (CCAR) and Dodd-Frank Annual Stress Test (DFAST) processes • Financial statement forecasting and models for conducting analysis
Liquidity management	<ul style="list-style-type: none"> • Cash flow projections for IHC and branch based on dynamic analysis over short- and long-term horizons which also consider contingent events • Stress testing analytics and models that support a consistent set of assumptions and impact analysis across the business and legal entity levels for at least four time horizons • Liquidity buffer calculation using daily internal and external cash flows for IHC and branches • Sensitivity analysis of stressed liquidity ratios to key assumptions related to macro-economic factors, P/L and balance sheet items, and reputational events • Monitoring of limits on funding concentrations by instrument-type, single counterparty, counterparty-type, secured and unsecured funding; liability maturities by time horizon; and contingent needs
Single counterparty credit limits	<ul style="list-style-type: none"> • Counterparty legal entity identifiers and mapping of counterparties across families • Exposure measurement and aggregation across entities on a daily basis within the same family, both on an IHC and consolidated US basis • Parallel calculation of derivatives exposure using Current Exposure Method and of securities finance exposure using pre-determined haircuts that depart from industry practice • Collection of: <ul style="list-style-type: none"> – Collateral / guarantees market values for calculation of exposure to the issuer of the collateral / guarantee – Issuer risk of securities in trading portfolios – Purchase price of securities for credit exposure measurement purposes • Inclusion of eligible hedges in the calculation, particularly for trading positions including equity derivatives and short positions • Reporting at the IHC and consolidated US level
Regulatory reporting	<ul style="list-style-type: none"> • Expansion of regulatory and financial reporting systems to cover approximately 20 separate and incremental Federal Reserve requirements, including: <ul style="list-style-type: none"> – Risk-based capital reporting for institutions subject to the advanced capital adequacy framework – Banking organization systemic risk report – Recordkeeping and reporting requirements associated with Regulation Y

Synergies with other global or US regulatory initiatives

As previously indicated, firms would benefit from taking a coordinated approach to addressing the EPS requirements that also considers other regulatory mandates that require similar capabilities. In many cases, efforts dedicated to (and the output from) these other initiatives may be leveraged to meet the requirements of the EPS, as described below.

Recovery and resolution planning

High level synergies exist between the data requirements for the EPS and the data needs for recovery and resolution planning. For firms in the initial stages of their resolution planning efforts, there is an opportunity for “one time” collection of certain information that can serve both purposes, including:

- Information and details regarding legal entity balance sheets
- Granular data around liquidity uses and sources
- Exposure information
- Data and methodologies used to estimate credit exposure

Capital approach and stress testing

For firms that own existing Bank Holding Companies (BHCs) and banks, it is very likely that some elements of the data production, storage, transformation and reporting can be leveraged for the IHC. While additional exposure types, data reporting elements or other IT enhancements will likely be identified, evaluating the ability of the firm to leverage these processes is a logical and efficient starting point. Firms currently subject to CCAR are being pressed to develop end-to-end solutions for capital stress testing, which promotes the concept of a golden source of data for financial reporting, regulatory reporting and management information. While this remains a longer term objective for many, we advise establishing a vision that links these initiatives together.

Liquidity stress testing

Similar to synergies with the capital approach and capital stress testing, firms may be able to leverage the liquidity stress testing processes that likely already exist at the bank or BHC. That said, liquidity stress testing at many firms can be less developed than what is expected by the regulators and any solution to align to expectations will need to be flexible given the anticipated evolution of these requirements. As with capital, the liquidity stress testing approach will need to consider a broader array of funding instruments and liquidity sources across the FBO’s US operations, including separate analysis for the IHC and US branches. A potentially greater challenge is related to the

daily calculation and monthly reporting of liquidity stress testing results and the resulting impact on the liquidity buffer.

Allowance for loan and lease losses

The Financial Accounting Standards Board has released a proposal to move all impairment accounting to an expected loss calculation over the life of the loan. This will once again draw on the same credit risk systems, data and resources affected by the regulatory reporting introduced by the EPS. Furthermore, the detailed calculations include a rolling nine-quarter profit forecast incorporating allowance for loan and lease losses under various stressed scenarios. Accordingly, the systems and data enhancements necessary to achieve compliance with the new financial reporting requirements will overlap significantly with IHC regulatory reporting requirements.

Conclusion

Following their gap analysis and DARR self-assessment, firms should have a clear picture of the status of data production, storage, transformation and reporting necessary to align to the EPS, as well as a view of where challenges exist. Based on any shortcomings, firms will need to create an actionable plan including decisions necessary to enhance the infrastructure. The action plan should include steps to execute identified initiatives, such as sequencing of activities, associated deliverables, estimated resource needs and timing.

Furthermore, given the broad range of requirements, firms will need to differentiate between the “must haves” and “nice to haves.” The action plan should also include an assessment of where to build out current systems and capabilities versus buying vendor systems or applications.

The expected “go live” date for implementation of systems and process changes driven by the EPS should be prior to the expected effective date of the rule in July 2015. However, firms should monitor and assess other planned and emerging rule changes. As an example, it is our view that the outcome of the Federal Reserve’s planned Quantitative Impact Study that was first noted in February 2013 testimony by Governor Tarullo will likely cause modifications to the Single Counterparty Credit Limits provisions, which we do not believe will be released until 2014.³

As we have described, there is considerable overlap and synergies with other rules and any solution would be best implemented if it considers the broader strategic needs of the firm.

³ See footnote 1.

Additional information

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