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First look

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

Produced by the Deloitte Center for Regulatory Strategies

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Foreword

For those who watch the Federal Reserve closely, it comes as little surprise that it has turned its attention to the growing influence of foreign banking organizations (FBOs). Of course, the Federal Reserve has always kept close tabs on FBOs, but the proposed prudential rule—required by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)—introduce a new level of discipline to its oversight given the growing influence of FBOs on the U.S. banking system. As FBOs have expanded their U.S. activities from traditional lending to more complex capital market activities, they may have also brought the potential for increased systemic risk.

After a decade in which the Federal Reserve's supervisory approach to FBOs remained virtually unchanged, the proposed rule introduces sweeping changes. Perhaps most significant, the proposed rule, if adopted, would mandate the structural form of the U.S. operations of FBOs and capital and liquidity requirements will be applied at the organizational level in the United States; essentially, FBOs would likely need to comply with many of the same proposed regulations that large U.S. banking organizations already must follow or will be expected to follow once domestic enhanced prudential standards are finalized. For many, achieving these goals may require organizations to inject significant additional captive capital, funding, and investments in local infrastructure—systems, data, modeling, and reporting that may have to be updated to meet different standards, processes that most likely have to be rethought and reengineered, and much more.

It goes without saying that this proposed rules is extensive—more than 300 pages in all. Faced with such a considerable volume of information, it may be hard to determine what is most important for your business today, much less where to start. In this document, we have highlighted some of the key provisions, offering a view of the most significant rule and their potential implications on companies that are U.S. subsidiaries of FBOs.

At least one thing is clear: the U.S. subsidiaries of FBOs would be required to operate under the same rule with which domestic banks have already been grappling. The proposed rules are likely to become law, so executives at FBOs should consider assessing the impact of the new rules on their organizations, which may potentially lead them to shift their business strategies. While this document should not replace your own thorough review of the rule, it is designed to serve as a primer for understanding its potential impact as quickly as possible.

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At a glance: Potential operating model impact

The Federal Reserve's proposal, which is expected to impose tougher rule on FBOs, will likely have broad effects across their organizations and U.S. activities. The proposed requirement that FBOs create an intermediate holding company (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, some FBO activities may likely be constrained. Plus, many FBOs may have to make significant changes to their governance models and infrastructures to become compliant. The chart below provides a quick overview of the measures being proposed across several areas and their impact across an FBO's IHC and U.S. branches and agencies.

Exhibit 1

The potential implications of proposed foreign bank enhanced prudential standards

Key areas of guidance	Potential requirement	Potential operating model impacts					
		Intermediate holding company			U.S. branches		
		Governance	Infastructure	Potential constraint on activities	Governance	Infastructure	Potential constraint on activities
Legal entity structure, governance, and compliance	Require FBO with total consolidated assets of $50 billion or more and combined U.S. assets of $10 billion or more to establish a U.S. IHC	■	■	■			
Capital	Implementation of capital and leverage requirements applicable to U.S. BHCs		■	■			
Liquidity	Implementation of U.S. liquidity standards, including Basel III, at IHC. Implementation of liquidity rules to be determined by the Federal Reserve and applied to branch	■	■	■		■	■
Single counterparty credit limits	Limits the credit exposure of both a U.S. IHC and the combined U.S. operations of an FBO to a single unaffiliated counterparty		■	■			
Risk management	Requirement to have a board level U.S. risk committee. Requirement to appoint a U.S. CRO for large FBOs. Risk governance in alignment with domestic enhanced prudential standards (proposed)	■	■		■ *Due to incorporation of liquidity requirements*	■	
Stress testing	Subject to the annual supervisory and semi-annual company-run stress test for large FBOs. FBOs with more than $10 billion but less than $50 billion would be subject to the annual company-run stress test		■	■		■	■
Early remediation	Establish early remediation triggers based on the risk-based capital and leverage, stress tests, liquidity risk management, and risk management	■	■	■			
Regulatory reporting/ data and infrastructure	Consolidated reporting for the unified structure and U.S. operations	■	■				

Source: Deloitte & Touche LLP

IHC/Governance requirements

The Federal Reserve has proposed that FBOs with assets of more than $50 billion globally and U.S. assets greater than $10 billion[1] create a single U.S. IHC[2] to hold all of their U.S. bank and non-bank subsidiaries. For the purposes of the IHC, the branches are specifically excluded. With the creation of this unified structure, the Federal Reserve may be able to consistently apply the enhanced prudential standards[3] across U.S. banking and non-banking subsidiaries on a comprehensive and consolidated basis. As a result, the IHC requirement provides the legal entity structure in which the quantitative prudential standards may be applied. It may also serve as a mechanism to achieve comparison and parity with existing domestic banking institutions.

Under the Federal Reserve's current oversight of FBOs, it has relied on the home-country regulator to effectively supervise FBOs on a global consolidated basis and has also depended on the FBO's parent to support U.S. operations under both normal and stressed conditions. Since the U.S. economic events of 2007-2009 and their aftermath, regulators have sought to establish consistent governance, compliance, and risk management structures within and across the U.S. operations of FBOs—not from rules that mandate but from supervisory guidance that provides standards for good governance and risk management operations models across the U.S. operations that effectively function like a virtual holding company. Under the proposed IHC structure, its management and board of directors are accountable to provide effective oversight and monitoring of legal entities and associated business line activities operating in the United States. The IHC, in line with recent regulatory developments, may also provide the Federal Reserve with a structure to facilitate the resolution of an FBO by providing one top-tier U.S. legal entity to be resolved or restructured.

With the creation of the IHC structure, there may be several far-reaching implications for FBOs, including the retention of capital, required leverage limits, and greater liquidity requirement. Additionally, other issues might arise, such as FBOs not complying with the IHC requirement, the potential migration of assets to branches or a parent company, interpretation of the definition of a "subsidiary," and potential tax and home-country legal implications.[4]

Here's a closer look at the IHC/governance requirements of the proposed rule and their potential implications.

[1] An FBO with combined U.S. assets less than $10 billion, excluding assets held by a U.S. branch or agency, would not be required to form a U.S. intermediate holding company.

[2] In exceptional circumstances the proposal would provide the Federal Reserve with the authority to permit an FBO to establish multiple IHCs.

[3] The exceptions are resolution planning requirements, which have been implemented separately, and credit exposure requirements, which will be proposed separately in the future.

[4] 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 has 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.

Highlighted sections[5]

- FBOs with assets of more than $50 billion globally and U.S. assets greater than $10 billion will be consolidated under an IHC, which will become the focal point for U.S. regulation. These FBOs must establish their IHCs by July 1, 2015.

- The IHC would be required to have a board of directors 'or equivalent' to provide a strong, centralized corporate governance system. The proposed enhanced prudential standards rule would imply that the U.S. management and board members would have appropriate oversight for U.S. operations. A management structure would presumably involve key business leaders and single points of contact from the control functions, internal audits, and a strong CEO.

- In exceptional circumstances, multiple IHCs would be permitted.

- The requirement for an IHC, which consolidates U.S. operations for FBOs, excludes any assets associated with U.S. branches or agencies as well as special commercial companies, referred to as 2(h) 2 companies that are currently exempt under the Bank Holding Company Act and not supervised by the Federal Reserve.

[5] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 39-47.

Possible implications

- While 107 FBOs would be subject to the proposed IHC requirement, only 23 of them with combined U.S. assets of $50 billion or more would be subject to the more stringent standards. This includes five of the 10 top U.S. broker-dealers owned by some of these FBOs. With the requirement that FBOs organize their U.S. subsidiaries into an IHC, the Federal Reserve would likely gain a more significant role in the supervision of these broker-dealers.

- The establishment of an IHC will likely promote a more consistent approach to risk and compliance management, governance, and supervision. It is likely to increase the overall accountability and responsibilities within a business operating in the U.S. and with the IHC's U.S. management and board of directors.

- With an IHC, the risk of total dependency on the foreign parent and/or home regulator to support U.S. operations in times of stress is likely to be mitigated because the U.S. management and board could supervise and self-govern to protect the institution's safety and soundness.

- Several changes may likely be required in the U.S. management reporting structure of FBOs to meet the new governance requirement, namely creating a structure that displays control and accountability within the U.S. to regulators. Key positions that would likely be analyzed are the CEO, CFO, and other key senior positions. While current expectations have increasingly required key single points of contact for the FBOs, such as a chief compliance officer, an FBO with combined U.S. assets of $50 billion or more would also need to hire a U.S. chief risk officer (CRO) and be subject to additional U.S. risk committee and financial requirements. As a result, these large FBOs may need to reorganize their risk structures, requiring a greater clarity of roles, responsibilities, and authority. Management and board accountability should be direct to the U.S. IHC. Any adjustments of the U.S. subsidiary's relationship to the parent may gain attention from their home regulator resulting in a possible negotiation between the parent and IHC.

- The IHC structure may also provide a vehicle for consolidated information for U.S. operations through application of current bank holding company (BHC) reporting (e.g., FR Y-9C) to the IHC.

- There may also be significant tax implications with the change of the corporate form or creation of the new holding company. Deferred tax assets and net operating losses and their impact on restructuring might also need to be examined. The impact may vary depending upon how the FBO's U.S. subsidiaries are currently structured and their individual tax positions. However, the timeline for restructuring is likely to be tight.

- The costs to establish and maintain an IHC will likely be significant because firms may need to establish the capabilities and infrastructure to integrate financial, operational, and legal entity information across underlying subsidiaries. The infrastructure would also need to support an integrated U.S. view for management, regulatory, and board reporting.

Risk management requirements

The Federal Reserve's proposed rule applies enhanced risk management standards to FBOs that are largely consistent with those for domestic institutions. Plus, the proposed rule addresses supervisory oversight challenges with FBOs that became evident during recent financial events. The proposed rule seeks to:

- Strengthen FBO oversight and risk management of their combined U.S. operations;
- Increase visibility of the risks posed to the stability of the U.S. financial system from the U.S. operations of FBOs; and
- Enhance the ability of large FBOs to effectively aggregate, monitor, and report risks across their U.S. operations on a timely basis.

At a high level, the proposed rule requires FBOs to annually certify with the Federal Reserve that they maintain a U.S. risk committee. Large U.S. FBOs must also establish a U.S. CRO. As it pursues enhanced risk management requirements, the Federal Reserve is assigning proposed standards based on the size of FBOs and the risks they are believed to pose to the U.S. financial system. The Federal Reserve is also providing a degree of flexibility to FBOs, allowing them to leverage their home-country governance structures. Finally, the Federal Reserve is asking for input on the specific structural requirements through an extensive series of questions contained in the proposed rule.

Here's a closer look at the risk management requirements of the proposed rule and their potential implications.

Highlighted sections[6]

- Publicly traded FBOs with total consolidated U.S. assets of $10 billion or more and all FBOs with total consolidated assets of $50 billion or more would be required to have a U.S. board-level risk committee (RC) (where at least one member has risk management expertise) that is responsible for overseeing U.S. risk management practices of the company. The FBO would also be required to certify annually to the Federal Reserve that it maintains a U.S. RC and that the U.S. RC has at least one risk management expert. FBOs could either make the U.S. RC a committee of the global board of directors (or equivalent) or of the U.S. IHC board. In the former case, FBOs can make the U.S. RC a standalone committee of the global board of directors or part of an existing enterprise-wide RC of the board.

- The level of risk management expertise contained in the U.S. RC should be commensurate with the capital structure, risk profile, complexity, activities, and size of the company's combined U.S. operations.

- FBOs with combined U.S. assets of $50 billion or more ("large FBOs") that conduct their operations in the U.S. solely through a U.S. IHC, would be required to maintain the U.S. RC as part of its U.S. IHC board.

- With respect to the U.S. RCs of large FBOs, the following additional requirements would apply above and beyond those described above:
  – The U.S. RC would be required to have at least one independent director as a member. The independent director is not required to be the chair of the U.S. RC.
  – The Federal Reserve generally expects that U.S. RC members at large FBOs would have an understanding of risk management principles and practices relevant to the U.S. operations of their company. U.S. RC members should also have experience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls with respect to banking organizations. The U.S. RC would be required to meet at least quarterly and to document and maintain records of its proceedings and risk management decisions.

[6] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 114-127.

- The U.S. RC at large FBOs is responsible for reviewing and approving the risk management practices of the combined U.S. operations and overseeing its risk management framework, which should include:
  - Risk governance, management, and control infrastructure policies and procedures;
  - Processes and systems to identify and report risks and risk management deficiencies, including emerging risks;
  - Processes and systems for monitoring compliance with risk policies and procedures;
  - Processes to ensure timely corrective action;
  - Specification of management and employees' authority and independence to carry out risk management responsibilities; and
  - Integration of risk management objectives with compensation structure.

- Large FBOs would need to appoint a U.S. CRO. This executive must be employed by a U.S. subsidiary or U.S. office of the FBO and cannot be the same person as the global CRO.

- For large FBOs, the U.S. CRO would specifically be responsible for:
  - Implementing and maintaining a risk management framework for the company's combined U.S. operations;
  - Overseeing the measurement, aggregation, and monitoring of risks undertaken by the company's combined U.S. operations;
  - Managing information regularly provided to the U.S. RC, the global CRO, and the Federal Reserve supervisory staff;
  - Administering regularly scheduled and special meetings with Federal Reserve supervisory staff; and
  - Being available to respond to supervisory inquiries from the Federal Reserve, as needed.

Possible implications

- The U.S. RC general requirements impact as many as 29 FBOs with $10 billion to $50 billion in global assets and an additional 84 FBOs with more than $50 billion in global assets but less than $50 billion in U.S. assets. The additional requirements for large FBOs, which impact as many as 23 FBOs with more than $50 billion in U.S assets, relate to the placement of the U.S. RC, inclusion of an independent director, specific responsibilities of the U.S. RC, and establishing a U.S. CRO with certain responsibilities and characteristics.

- The proposed rule creates an expectation that the risks from U.S. operations of large FBOs will be monitored, measured, and managed similarly to domestic institutions, with some changes to allow for the structure of FBOs. FBOs would be required to develop and perform reporting across their U.S. operations for overall U.S. risk management, stress testing, capital, and liquidity planning. Governance would be tightened by requiring an RC of the board that is focused exclusively on U.S. operations. Large FBOs would also be required to have a U.S. CRO, who would provide visibility into the FBO by serving as a central point of communication with the Federal Reserve.

- FBOs will likely have to evaluate the capabilities of their current U.S. operations in order to identify areas that need to be strengthened to meet the new requirements. This may significantly impact reporting, technology, operations, staffing, capital and liquidity allocations, governance and operating model, risk and return goals, and overall strategy and management. For example, an FBO that is currently operated via vertical business lines within the global enterprise would now have to be viewed within the context of the U.S. operations, subject to specific risk management, capital, liquidity, stress testing, and organizational requirements.

- FBOs will likely need to make an assessment of their current U.S. infrastructure, governance, and human capital functions in order to meet new requirements, such as:
  - The requirement to hold liquidity and capital within the United States (rather than the parent company) may spur FBOs to evaluate their U.S. balance sheets from a strategic and efficiency standpoint;
  - FBOs that operate in the United States with a streamlined or less senior management team may have to decide if they can continue to do so under the new expectations;
  - FBOs may need to evaluate their current governance and operating models and adjust them as necessary to better align with the proposed changes and provide clear roles, authority, and accountability between U.S. and global entities; and
  - Management information systems will likely need to be reconfigured to enable the U.S. RC and the CRO to meet new aggregation and reporting requirements focused on U.S. operations.

- FBOs may find the costs of operating in the United States could increase as they adjust their U.S. operations to conform to the new rule.

Capital requirements

Under the proposed rule, U.S. IHCs of FBOs would be subject to the same capital rule as U.S. BHCs. For some FBOs, this may have the effect of trapping significant additional capital in the United States over and above the current amount of capital that is required to be held in regulated subsidiaries. Risk-based capital requirements, leverage limits, and capital distribution restrictions would have to be applied to IHCs in the same manner, and to the same extent as those currently in place at U.S. BHCs. As a result, some FBOs will likely need to raise more, higher-quality capital or downstream capital and hold it captive in the United States at the IHC level. Executive management of FBOs may choose to reassess their strategy in light of these requirements, potentially reorienting their businesses to account for the potential impact on return on equity.

The reason for imposing the same capital (and liquidity) requirements at the IHC level is both to strengthen the resiliency of the U.S. operations of FBOs and to create parity between these operations and U.S. BHCs. While U.S. capital requirements would not be applied to the U.S. branch and agency network, FBOs would need to certify or demonstrate that they meet capital adequacy standards on a consolidated basis in a manner consistent with the Basel Capital Framework.

Size matters when determining which U.S. capital standards and the type of supporting infrastructure are applicable. For example, U.S. institutions with $250 billion or more in assets, and/or $10 billion in foreign exposure, are required to implement the advanced approaches under U.S. Basel II (and U.S. Basel III, which is not yet final). Meanwhile, institutions that don't cross these applicability thresholds and do not voluntarily elect to adopt the advanced approaches will be required to apply the U.S. version of Basel I or, once the U.S. version of the Basel III is finalized, the so-called standardized approach.

While many larger FBOs have already implemented Basel II and are well on the way to Basel II.5 and III at the consolidated foreign parent bank level under their home-country rules, there are a number of important technical and supervisory differences in the U.S. Basel requirements versus foreign parent home-country requirements, including the requirement under the Dodd-Frank Collins Amendment that the risk-based requirements be subject to the U.S. general risk-based (or Basel I) floor and the prohibition under the Dodd-Frank Act against relying on external credit ratings in calculating regulatory capital. As a result, many FBOs may need to rethink portions of their Basel implementation in order to conform to the U.S. rule at the IHC level. They may also need to build out their systems and infrastructure to accommodate extensive U.S. reporting requirements.

It's also worth noting that U.S. IHCs with $50 billion or more in assets would be subject to the U.S. capital plan rule. They would be required to submit an annual capital plan, which details requests to pay dividends or repurchase shares and demonstrates that the resulting capital position would exceed the required minimum over a range of adverse scenarios over a nine-quarter forward-looking horizon. The IHCs would have to report the stress testing results to the Federal Reserve and to the public. And, like similarly sized U.S. banking organizations, the IHCs would also have to demonstrate that their risk measurement, loss and available capital resource estimation, independent model validation, decision processes, controls, and governance over the stress testing process are suitably robust and consistent with their size and complexity.

Supporting these capital planning processes, while complying with supervisory expectations, will likely require IHCs to build out their local infrastructure. While U.S. IHCs with total consolidated assets greater than $10 billion and less than $50 billion would not be subject to the capital plan rule, they would be subject to the applicable stress rule. Meeting these expectations may require large investments in local infrastructure.

All of this is expected to happen by July 1, 2015—an aggressive timeline for a number of reasons. For example, if significant additional capital is needed, it may take time to understand the capital implications, modify the business strategy to minimize the negative effect on return on equity, and raise any additional needed capital. And because infrastructure may have to be adapted or significantly reworked—everything from systems and data to modeling, reporting, and governance—it will likely require time to properly sequence and implement those changes.
Here's a closer look at the capital requirements in the proposed rule and their potential implications.

Highlighted sections[7]

- U.S. IHCs with more than $10 billion and less than $50 billion in U.S. assets would be required to meet the U.S. BHC capital rule—general risk based capital, leverage rule, market risk rule (if trading requirements are met), and the U.S. proposed Basel III rule (as and when adopted), and stress testing requirements for greater than $10 billion or less than $50 billion institutions.

- U.S. IHCs with $50 billion or more in assets would be subject to the same requirements as above, plus the final capital plan rule governing capital distributions. IHCs crossing either applicability thresholds of $250 billion in assets or $10 billion in foreign exposure would be required to implement the U.S. advanced approaches for risk based capital.

- U.S. IHCs (if designated as a systemically important banking organization, D-SIB [as and when adopted]), would require an additional risk based capital surcharge.

- FBOs with total consolidated assets of $50 billion or more would have to certify that they meet the consolidated regulatory capital standards within their home jurisdiction and that they are consistent with the Basel Capital Framework, including Basel III and future amendments to this framework. Although the proposal would not require the U.S. leverage ratio at the consolidated parent level, the Federal Reserve notes that the FBO would be expected to implement the supplemental leverage ratio, which is required under Basel III by 2018.

- Under a separate proposed rule, the Federal Reserve may introduce a consolidated capital surcharge requirement for FBOs with total consolidated assets of $50 billion that are designated by the Basel Committee on Banking Supervision as a global systemically important bank (G-SIB).

- Aside from the above-mentioned capital rule, leverage restrictions could be placed on an FBO by the Financial Stability Oversight Council (FSOC) if it is determined that the FBO poses a grave threat to U.S. financial stability. In that case, the FSOC must require the FBO with consolidated assets of $50 billion or more to limit its debt-to-equity ratio to no more than 15-to-1 as a means of mitigating systemic risk.

7 http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 47-58.

Possible implications

- Applying capital requirements at the IHC level has the potential to trap significant additional capital beyond what FBOs are already required to hold in regulated U.S. subsidiaries, driving up the cost of capital. IHCs with significant goodwill and other intangibles are likely to be particularly impacted, given the Basel requirement that these be deducted from Tier 1 capital. Similarly, holding companies with extensive U.S. nonbank subsidiaries—which tend to be subject to different regulatory capital requirements and in some instances less stringent or no regulatory capital requirements—may also need to raise additional capital as they consolidate these entities into the IHC and apply U.S. BHC capital requirements to them. The July 1, 2015 deadline for compliance may prove challenging, especially if significant additional capital must be raised or injected.

- The ability to downstream debt from the IHC in the form of equity (or so-called "double leverage") to subsidiaries within the holding company chain will likely also be constrained given longstanding supervisory scrutiny regarding double leverage levels at U.S. BHCs.

- Regulatory capital is increasingly serving as a binding constraint on business activities and receiving heightened attention from shareholders, boards of directors, and regulators. The introduction of additional trapped capital is likely to put further pressure on increasing capital efficiency in the United States as a byproduct of the new regulations. This may require a more proactive management approach within the U.S. operations of FBOs to determine the additional cost of capital on transactions booked with the IHC structure, and to make decisions based on these results.

- The operational requirements for calculating capital ratios in accordance with applicable U.S. standards may prove challenging—especially for larger IHCs required to adopt the U.S. advanced approaches under the U.S. Basel requirements—given the relatively short deadline of July 1, 2015. Systems, data, modeling, and reporting mechanisms may all be affected, requiring a significant reworking of the infrastructure. Although many FBOs are already implementing Basel II.5 and III at the consolidated foreign parent bank level under their home-country rules, the U.S. implementation of the rules differs in some important ways. Plus, significant resources are likely to be required to solicit approvals from the Federal Reserve and demonstrate that implementation at the U.S. IHC is consistent with U.S. standards.

- For IHCs with assets of $50 billion or greater, the ability to pay dividends or upstream funds would be subject to Federal Reserve approval and has the potential to be denied if prospective capital positions on post-stress basis or the stress testing process is not in line with supervisory requirements and expectations. This could lead FBOs to raise or inject further capital in their IHCs and potentially further drive up the cost of capital. To support capital planning processes, IHCs will likely need to build out their local infrastructure to comply with the supervisory expectations. Although U.S. IHCs with total consolidated assets of greater than $10 billion but less than $50 billion are not subject to the capital plan rule, they would be subject to the applicable stress rule, which is also likely to require significant investment in local infrastructure to meet supervisory expectations.

Liquidity requirements

In the lead-up to the events of 2007-2009, many FBOs used their U.S. operations to raise short-term U.S. dollar-denominated debt in U.S. markets to fund longer-term assets held in other jurisdictions. During that period and, more recently, the economic events in Europe, the U.S. operations of some FBOs experienced liquidity stresses partly due to heavy reliance on short-term, U.S. dollar wholesale funding. The use of consolidated liquidity risk management by some FBOs has contributed to this reliance and an asymmetric pattern wherein the U.S. branch and agency network provides the parent with net longer-term funding and the parent provides short-term funding to the U.S. operations.

To address these risks and help establish parallel treatment between U.S. domestic institutions and the U.S. operations of FBOs, the new proposed rule would implement a set of liquidity requirements for FBOs that build on the core provisions of the Federal Reserve's SR Letter 10-6 ("Interagency Policy Statement on Funding and Liquidity Risk Management") issued March 17, 2010.[8] The newly proposed requirements are also broadly consistent with risk management requirements for U.S. BHCs contained in the December 2011 enhanced prudential standards proposal for domestic firms. The proposed liquidity requirements for U.S. operations of FBOs seek to increase the overall liquidity resiliency of these operations during times of market-wide stress and reduce the threat of asset fire sales during periods when U.S. dollar funding channels are strained and short-term debt cannot easily be rolled over. The intent of the proposed liquidity requirements is to reduce the reliance on parent and government support during periods of stress. The proposed rule seeks to provide an incentive for FBOs to better match the term structure of funding provided by the U.S. operations to the head office with funding provided from the head office to the U.S. operations.

Here's a closer look at the liquidity requirements of the proposed rule and their potential implications.

Highlighted sections[9]

Liquidity requirements

- For FBOs with combined U.S. assets of $50 billion or more, the proposed rule would impose liquidity requirements largely similar to those set forth in the December 2011 proposal applicable to large domestic BHCs. The proposed rule would apply a more limited set of requirements to FBOs with a smaller U.S. presence.

- Regarding U.S. operations of FBOs with combined U.S. assets of $50 billion or more, the proposed rule would convert existing liquidity risk management guidance into rules. These FBOs would be required to:
  – Meet liquidity risk management standards;
  – Conduct monthly internal liquidity stress tests; and
  – Maintain a significant buffer of highly liquid assets in the U.S. (see liquidity buffer discussion below).

Risk management standards

The risk management standards would require an FBO, with respect to its combined U.S. operations, to:

- Adopt specific corporate governance practices regarding liquidity risk management;
- Project cash flow needs over various time horizons;
- Develop specific limits relating to liquidity metrics, and maintain a contingency funding plan.

Liquidity stress testing

- An FBO with total global combined U.S. assets of $50 billion or more must conduct stress tests of its cash flow projections separately for its IHC and for all its U.S. branches and agencies, at least monthly. The results would be used to determine the size of its liquidity buffers and contingency funding plans. The proposal imposes general requirements for time horizons, scenarios, and assumptions.

Liquidity buffer

- The U.S. IHC would be required to maintain the full 30-day buffer in the United States. However, the U.S. branch and agency network would only be required to maintain the first 14 days of its 30-day buffer in the United States and would be permitted to meet the remainder of the requirement at the parent consolidated level.

- The FBO may maintain the remaining liquidity buffer for the U.S. branch and agency network outside the United States, as long as it has demonstrated to the Federal Reserve's satisfaction that it, or one of its affiliates, could provide the residual liquid assets to the U.S. branch and agency network if needed.

[8] http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.pdf
[9] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 58-96.

Basel III liquidity ratios

- Through future separate rulemakings, the Federal Reserve intends to implement Basel III's quantitative liquidity ratios—including the liquidity coverage ratio and the net stable funding ratio—for the U.S. operations of some or all FBOs with $50 billion or more in global combined U.S. assets. This would be consistent with the international timeline.

FBOs with smaller U.S. footprints

- FBOs with combined U.S. assets of less than $50 billion would be required to report the results of an internal liquidity stress test, either on a consolidated basis or for its combined U.S. operations, to the Federal Reserve on an annual basis. If an FBO did not satisfy this requirement, its U.S. branch and agency network would be subject to intragroup funding restrictions.

Possible implications

- **Board of directors and management.** Boards will ultimately be responsible for the liquidity risk assumed by the U.S. operations of an FBO and/or legal entity conducting transactions in U.S. dollars outside the United States. Liquidity risk management is not a topic that boards and risk committees typically have experience with, particularly in organizations in which the complexity, activities, size, and risk-related factors would need to be clearly understood. Plus, senior management would need to make difficult decisions —such as on new business opportunities, costs associated with compliance, messaging of strategy to the board, messaging of liquidity position/stress testing to the markets, among others—to comply with the requirements.

- **Operational support/infrastructure.** Processes and technologies are also likely to be impacted. To provide sufficient monitoring, it may take significant investments and the re-engineering of processes and reporting architectures to comply with, for instance, intraday reporting, daily reporting, and ad-hoc stress testing to accommodate local reporting. A higher level of data quality may be required across a global complex organization.

- **Risk management.** A U.S. CRO, with experience in liquidity risk issues, must be appointed to provide an independent view of liquidity risk. The position's role and responsibilities must be delineated.

- **Lines of business.** Profitability and risk profiles could be significantly altered and impacted.

- The Federal Reserve would also assess whether the home-country supervisor conducts capital and liquidity stress testing on the FBO and if it is broadly consistent with the U.S. standard. For FBOs with U.S. assets of $50 billion or more if the stress testing results highlight potential mismatches in funding, the Federal Reserve would require significantly more detailed information. If the U.S. requirements were not met, asset maintenance (or the requirement that eligible assets equal a greater percentage of third-party liabilities) of 108 percent would be imposed on the U.S. branch agency network. In addition, the Federal Reserve could impose additional measures, such as intragroup funding restrictions or increased local liquidity requirements, if supervisory expectations are not met.

- The combination of captive liquidity buffers at both the IHC and the U.S. branch and agency network levels, the analysis of home-country stress testing results, and the emphasis on whether the branch and agency network is in a position to provide net funding to the parent and to ensure a high-quality liquidity buffer is kept in the U.S. to meet liabilities has the potential to significantly reduce the flexibility of some FBOs to manage liquidity on a centralized basis and to increase costs.

Stress testing requirements

Under the new proposed enhanced prudential rule, stress testing is enshrined as an critical tool for assessing the prospective ability of the U.S. operations of FBOs to maintain sufficient capital and resiliency under adverse conditions over a period of time. Like U.S. BHCs, IHCs would be required to perform supervisory stress tests using the standards that have been set forth based on the asset size categories of either greater than $10 billion but less than $50 billion, or $50 billion or greater. Results of stress tests and supporting information are required to be reported to the Federal Reserve and publicly disclosed.

Domestic institutions appear to have had a challenging time implementing U.S. stress testing requirements—and FBOs might follow a similar path. With U.S. requirements and supervisory expectations relatively firm and far reaching, meeting them will likely require infrastructure investments in management information systems, model estimation and validation, processes, controls, governance, and reporting. Establishing a sustainable, efficient, and transparent process appears to continue to be a challenge for many U.S. organizations.

Somewhat less direct stress testing requirements would also be applied to the U.S. branch and agency networks of FBOs. The Federal Reserve would have to evaluate whether an FBO's home-country supervisor conducts stress testing and if it is broadly consistent with U.S. standards. If the Federal Reserve determines it's inconsistent with U.S. standards and/or the stress results for FBOs with U.S. assets of $50 billion showed that the U.S. branch and agency network was a net funder of the parent or other non-U.S. affiliates, among other criteria, the Federal Reserve would impose asset maintenance on the U.S. branch and agency network. It could also restrict intragroup funding and increase local liquidity requirements, if necessary.

Here's a closer look at the stress testing requirements of the proposed rule and their potential implications.

Highlighted sections[10]

Similar to the U.S. domestic rules, the proposed FBO rules distinguish stress testing requirements for IHCs in two categories based on asset size.

- IHCs with total consolidated assets of $50 billion or more would be required to conduct stress testing and to submit a capital plan for approval to pay dividends and/or other capital actions in accordance with the Federal Reserve's final capital plan rule and its supervisory and company-run stress test requirements for covered companies. These institutions must meet the same requirements of similarly sized U.S. BHCs that are subject to this rule. IHCs would be required to conduct two company-run stress tests per year—one test using scenarios provided by the Federal Reserve (the annual test) and the other using scenarios developed by the company (the mid-cycle test). Not only must stress test results be reported to the Federal Reserve with detailed supporting information, but they must also be publicly disclosed. The IHC's risk identification, estimation, stress testing, capital adequacy assessment process, and supporting controls and governance are expected to be consistent with seven key principles outlined in the final capital plan rule and updated in additional supervisory guidance.

- IHCs with total consolidated assets of more than $10 billion but less than $50 billion would be required to conduct an annual company-run stress test, using scenarios provided by the Federal Reserve. These IHCs must then submit the results to the Federal Reserve, and publicly disclose them. Although the requirements are somewhat less stringent than for larger institutions, these IHCs must meet similar supervisory expectations to comply with the applicable final rule.

[10] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 127-142.

- U.S. branch and agency networks of FBOs would also be subject to stress testing requirements. If the U.S. branch and agency network of an FBO with combined U.S. assets of $50 billion or more fails to meet the Federal Reserve's stress testing requirements, it would result in asset maintenance of 108 percent at the U.S. branch and agency network—which is effectively a capital charge of 8 percent. The Federal Reserve could also impose limits on intragroup funding and increase local liquidity requirements. The key requirements that must be met include:
  - The FBO be subject to stress testing by the home-country supervisor that is broadly consistent with the U.S. framework;
  - The FBO provides certain information on its stress tests to the Federal Reserve; and
  - If the U.S. branch and agency network is a net funder of the parent or other non-U.S. affiliates, then the FBO must provide additional information to the Federal Reserve so it can evaluate whether the FBO has sufficient resources to absorb losses under stressed conditions.

- For U.S. branch and agency networks of FBOs with total consolidated assets of more than $10 billion, but combined U.S. assets of less than $50 billion, the FBO must be subject to a consolidated stress testing program broadly consistent with the U.S. process. If the FBO does not meet these requirements, the U.S. branch and agency network would be required to maintain eligible assets equal to 105 percent of third-party liabilities (asset maintenance).

- For FBOs with global assets greater than $10 billion and less than $50 billion with U.S. assets less than $10 billion, the FBO's home-country stress testing requirements should be broadly consistent with U.S. requirements.

- Annual stress tests are required to be filed by January 5 of each year, and the FBO must publicly disclose a summary of the results under the severely adverse scenario in mid- to late March. For the mid-cycle stress tests, filing should be done by July 5 each year, and public disclosure made by mid- to late September.

Possible implications

- Stress testing results may be binding from a capital perspective and could require that additional capital be raised or injected in order to meet required minimum ratios under the early remediation standards. This may result in lowering the return on equity for U.S. IHCs and spur a reorientation of the business strategy in the United States.

- Stress testing on capital should also be linked to the liquidity risk profile of the institution to assess U.S. operations are managed within the established risk tolerance. Results may cause reconsideration of the appropriate liquidity levels for the FBO's U.S. operations including its net due to/from funding position as well as its asset mix strategy.

- Publicly disclosing stress testing results could potentially show an IHC in a favorable and/or unfavorable light compared with its peers, including U.S. BHCs. If an IHC appears less well-capitalized, the market may react negatively.

- Significant resourcing, infrastructure investments, or governance adaptations are likely necessary to comply with the U.S. stress testing requirements.

- Use of the U.S. branch and agency network as a net provider of funding to its parent or non-U.S. affiliates could be constrained for FBOs with U.S. assets of $50 billion or greater unless the FBO can demonstrate to the Federal Reserve that it has sufficient capital resources to withstand stressful conditions and that the stress testing is appropriately robust.

Early remediation requirements

Under the proposed rule, the combined U.S. operations of an FBO would be subject to early remediation triggers based on capital ratios, stress tests, risk and liquidity risk management, and market indicators. These metrics are generally similar to the rule proposed for domestic banking organizations in December 2011. However, there are some nuances in the proposed rule that address the unique operating nature of FBOs, such as foreign branching.

An FBO with combined U.S. assets of $50 billion or more that breaches an early remediation trigger would be subject to a set of nondiscretionary remediation actions along with the potential for discretionary remediation actions imposed on its U.S. operations. FBOs with a smaller U.S. presence would not be automatically subject to remediation actions. However, supervisors may undertake some or all of the actions imposed on the larger banks.

The remediation actions are restrictive and are aimed at strengthening the U.S. financial markets by holding U.S. activities of FBOs to the same stringent remediation actions applied to U.S. banking organizations. When finalized, the various proposed triggers and subsequent remediation actions will likely remain similar to what has been proposed.

Here's a closer look at the early remediation requirements of the proposed rule and their potential implications.

Highlighted sections[11]

- The proposed rule is broadly consistent with proposed domestic requirements issued in December 2011, but reach beyond U.S. IHCs to foreign parents. In addition, the new rule imposes restrictions and remediation actions for U.S. branches of FBOs (e.g., a 30-day liquidity buffer), which are held outside of the U.S. IHC. Similar to other provisions, the early remediation requirements could potentially be seen by foreign bank supervisors as extraterritorial.

- The early remediation requirements would impact U.S. operations of foreign banking organizations with total consolidated U.S. assets of $50 billion or more. Before, remediation was subject to regulatory discretion. Under the new rule, remediation standards have automatic triggers, which have mandated and enforceable actions when breached. As a result, the Federal Reserve will likely need to communicate with the home-country regulator each time the U.S. operations of an FBO move between the four prescribed trigger levels under the framework. Additionally, U.S. operations of foreign banking organizations would also be required to self-report to the Federal Reserve when they become aware of a breach of a trigger, which will likely require a significant action on the part of the U.S. IHC, including reporting to the Federal Reserve.

- The early remediation requirements would need to be coordinated with the resolution plans rule requirements that are already imposed upon FBOs. This means they must coordinate home-country recovery and resolution requirements with prescriptive U.S. resolution planning and early remediation requirements. As these requirements are not completely consistent, FBOs may have to put in extra effort to meet them.

- Level 4 recommended resolution of the proposed framework gives the Federal Reserve the ability to resolve the U.S. operations of an FBO. At both the U.S. IHC and at the foreign parent level, the proposed rule would provide specific regulatory capital cut-offs (not stress capital related) in which the Federal Reserve would consider whether the combined U.S. operations of the FBO warrant termination or resolution. This is similar to the domestic requirement in which the Federal Reserve can recommend a company be resolved under the orderly liquidation authority under Title II of the Dodd-Frank Act. It would require significant coordination with the home-country regulator, and would involve activating the resolution planning process, so both the Federal Reserve and the FDIC would be involved. The process should be viewed as a continuum starting with business as usual, through early remediation, and concluding with resolution planning.

[11] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 142-172.

Possible implications

- The proposed rule is prescriptive, far-reaching, and will likely force FBOs to become compliant in a very short amount of time. When a trigger is breached there can be restrictions that will likely require some level of disclosure that may in turn result in adverse public reaction. FBOs may also have to deal with the potential for memoranda of understanding and written agreements that would require corrective action and status reporting.

- FBOs are likely to critically analyze their U.S. business operations, because the proposed rule would require them to house those operations (with the exception of U.S. branches) under an IHC. This will likely impact the resolution planning process with regard to any structural changes—but those changes may have a positive impact on resolvability. A detailed legal entity analysis will likely be required to evaluate the nature of future U.S. operations from a legal standpoint (e.g., tax planning and business strategy issues).

- The FBO's cost of doing business in the United States may rise as a result of necessary structural changes. Due to the nature of the proposed rule—such as the deadline for compliance, higher capital and liquidity requirements, and risk management infrastructure demands—many FBOs may have to make significant investments in evaluating and changing their organizational structure and infrastructure. This will likely put pressure on their bottom lines.

Single counterparty credit limit requirements

In a bid to limit their interconnectedness, the new rule requires the U.S. operations of FBOs to take an enterprise view of single counterparty credit limits. The proposed rule would also require that these organizations meet the difficult task of aggregating net credit exposures across U.S. legal entities. Where limits are exceeded, exposures would be adjusted downward. Exposures to very large counterparties may need to be lowered significantly.

Meanwhile, it is also important to consider that an FBO's credit counterparties will likely be making the same assessments and potentially reducing exposures. This would require an internal review of funding sources in light of risk to liquidity.

The proposed rule introduces a host of new responsibilities for leaders at FBOs. For starters, the proposal would impose a two-tier, single counterparty credit limit on organizations with $50 billion or more in assets. Such organizations would face a net credit exposure limit of 25 percent of capital stock and surplus between U.S. IHCs or combined U.S. operations of the FBO and a single unaffiliated counterparty. The proposed rule also imposes a more stringent net credit exposure limit to credit counterparties with total assets of $500 billion or more.

There are a number of requirements and calculations permitted regarding net credit exposure. Each type of credit transaction would affect net credit exposure, a fact that FBO leaders must take into account when making business decisions. And that's just the start: the net credit position can be affected by eligible collateral, guarantees, credit and equity derivatives, hedges, securities financing transactions, and more.

For many, these changes may have a significant impact on their reporting processes. For FBOs, compliance is required on a daily basis. Even monthly compliance reports must demonstrate daily compliance. FBOs must ensure the compliance of their U.S. operations.

Here's a closer look at the single counterparty credit limit requirements of the proposed rule and their potential implications.

Highlighted sections[12]

- The proposed rule would impose a two-tier, single counterparty credit limit on FBOs, specifying a 25 percent net credit exposure limit between their U.S. operations and a single unaffiliated counterparty.
- A lower limit of between 10-25 percent applies to counterparties of $500 billion or more in total assets.
- Compliance is required on a daily basis—at the end of each business day. Monthly compliance reports must demonstrate daily compliance. FBOs must ensure the compliance of their U.S. IHCs and combined U.S. operations.

[12] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 96-114.

Possible implications

The proposed rule regulating single counterparty credit limits set the 25 percent net credit exposure limit for FBOs with $50 billion or more in assets. The more stringent limits apply to FBOs with $500 billion or more in assets, as well as financial counterparties of similar size. This list includes BHCs or FBOs with total assets of $500 billion or more, along with their respective subsidiaries, and any nonbank financial company supervised by the Federal Reserve.

- Leaders at FBOs should consider taking an enterprise view of credit risk, with the ability to continuously monitor, assess, and report aggregate net credit exposures to counterparties across U.S. legal entities, as well as on a consolidated basis.
- Where limits are exceeded, exposures must be assessed and adjusted appropriately. Plus, FBO leaders must recognize that credit counterparties are making the same assessments and adjustments, requiring them to reassess risk-to-liquidity and other dependencies.
- Many FBOs will likely have to make significant improvements to their reporting processes and technological capabilities. For some, their current systems may not be sufficiently prepared for daily compliance reports, both within the U.S. IHC and for combined U.S. operations.
- Tier 1 common equity levels may be subject to increased scrutiny. The credit exposure limit is calculated based on the capital stock and surplus of the U.S. IHC and FBO. This proposed rule may open the door to alternate measures of capital stock and surplus—which may now focus on common equity. This appears to be consistent with recent moves elsewhere to focus on Tier 1 common equity as the primary measure of loss-absorbing capital for internationally active banking firms.
- Prepare for a potentially conservative interpretation of the proposed rule's definition of control when taking account of the credit exposures of an FBO's U.S. subsidiaries.

Regulatory reporting requirements

In addition to existing regulatory reporting requirements for FBOs operating in the United States, the Federal Reserve has proposed enhanced prudential standards that would impose significant additional reporting burdens on FBOs and their U.S. IHCs. In short, all IHCs would be required to submit the same reports as U.S. bank and savings and loan holding companies.

The complexity and volume of reporting for the newly formed IHCs, pushed along by an accelerated timeline (by July 1, 2015), will likely present FBOs with a host of significant and immediate challenges. For example, FBOs will likely need to assess the applicability of each reporting requirement to their IHCs, develop and document reporting processes for applicable reports, enhance existing infrastructure or build out new infrastructure, and provide adequate governance framework and subject matter knowledge—all activities that could consume substantial time and resources. The complexity of the reports, combined with the granular level of required data, will likely present challenges in many areas of the organization, including:

- Data collection and aggregation processes;
- Mapping of accounting, transactional, and reference data;
- Technology solutions for interfacing with existing systems and streamlining of key processes; and
- Overarching governance, documentation, and data consistency across risk, regulatory, financial, and management reporting.

Management executives of FBOs may also find it important to focus on activities such as evaluating and enhancing the legal entity controllership function, better understanding intercompany relationships, and providing oversight to provide consistent and sustainable reporting across all legal entities with the IHC. Plus, FBOs may consider conducting an assessment of its financial reporting practices to facilitate U.S. generally accepted accounting principles (GAAP) compliance.

Here's a closer look at the reporting requirements of the proposed rule and their potential implications.

Highlighted sections[13]

The proposed rule has outlined a set of BHC reports that IHCs would need to begin filing after July 1, 2015. The majority of these reports would have to be filed quarterly or annually, with an exception of the event-driven report (FR Y-10) that would need to be filed initially after an IHC has been created for all affected entities within the IHC, and then when any subsequent changes to the IHC structure are made.

Here's a closer look at some of the required reports. We have highlighted the consolidated reports that may present the most significant challenges to FBOs due to the complex proposed rule and granular data requirements.

- **FFIEC 009 – Country exposure report**
  - This includes direct and indirect exposure (claim) positions against all applicable countries;
  - U.S. branches and agencies of FBOs already file a similar report (FFIEC 019); and
  - The primary challenge will likely be to identify and collect required risk data (e.g., country of ultimate risk, guarantees, and branch/parent relationship).

- **FFIEC 101 – Risk-based capital reporting for institutions subject to the advanced capital adequacy framework**
  - This report would most likely be required of the largest and more complex IHCs with total consolidated assets exceeding $250 billion;[14]
  - Top U.S. banking organizations that are subject to FFIEC 101; and
  - Implementation of this reporting requirement may prove to be very lengthy and costly.

13 http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf, p. 184-190.

14 Refer to Appendix G to the Federal Reserve Regulation Y, Bank Holding Companies and Change in Bank Control (CFR Part 225) – Capital Adequacy Guidelines for Bank Holding Companies: Internal Ratings-Based and Advanced Measurement Approaches

- **FR Y-9C – Consolidated financial statements for BHCs**
  - This may be considered the most challenging report for IHCs;
  - It requires consolidation of all U.S. operations of an FBO, including banks, broker-dealers, insurance entities, and all other subsidiaries (except for its branches and agencies); and
  - This includes consolidated balance sheet and income statement and more than 20 supporting schedules for specific products and off-balance sheet activities, including calculation of regulatory capital.

- **FR Y-9LP – Parent company only financial statements for large BHCs**
  - The balance sheet, income statement, and supporting schedules relating to investments, cash flow, and other activities of the IHC on a parent-only basis are required here.

- **FR Y-12 – Consolidated BHC report of equity investments in nonfinancial companies**
  - The primary focus of the report is to identify and track such equity investments on a portfolio basis across the IHC.

- **FR Y-15 – Banking organization systemic risk report (the report was implemented in December 2012)**
  - The FR Y-15 is an annual report used by the Federal Reserve to monitor, on an ongoing basis, the systemic risk profile of BHCs and to determine the additional capital requirement for G-SIBs; and
  - This would require FBOs to report consolidated information from both IHCs and U.S. branches and agencies.

- **FR Y-14M and Q – Capital assessments and stress testing**
  - This report is very complex and requires significant effort, primarily within treasury, capital planning, finance, and risk management functions.

Possible implications

The new rule will likely require significant investment in personnel, processes, and technology, coupled with the relatively short implementation timeline (the first set of quarterly reports may need to be filed as of September 30, 2015). The primary activities of the implementation include:

- Establishing an entity-wide implementation roadmap based on a detailed assessment of requirements, applicability, and data availability, documenting future-state processes, prioritizing, and staging reports.
  - From a regulatory reporting perspective, the proposed effective date for the in-scope entities is July 1, 2015. The build-up of the project plans will likely need to take into account short-term (interim) solutions to ensure filing of the initial sets of the reports by September 30, 2015. The longer-term activities will likely focus on developing a sustainable, robust, and well-controlled report preparation process.
- Developing processes and controls around data collection, aggregation, accounting, and reporting at the consolidated level and more effective controls for individual legal entities to facilitate stand-alone reporting for the IHC and individual legal entities.
  - BHC reports will likely require a greater level of balance-sheet detail than is available from current general ledger processes. It will also likely require more off-balance-sheet data, including commitments, derivatives, and securitization. All reports are likely to require improved integration of the balance sheet into management reporting, and a clear delineation of roles and responsibilities between operations, controllership, and treasury.

- Enhancing a regulatory reporting governance framework and developing related documentation around key reporting processes.
  - IHCs should consider setting up an entity-wide regulatory reporting policy with elements of accountability, roles and responsibly, risk assessment, and key report preparation standards. Additionally, procedures for individual reports would likely need to be documented and implemented. Plus, personnel involved in the new reporting processes would likely need to be trained in the new requirements or hired from the industry with limited regulatory reporting resources.
- Outlining the business requirements for a potential technology solution to automate reporting processes —and enhancing existing data governance processes and improving source data quality along the way.
  - The organization will likely need to assess the "in-scope" application set and interfaces to document the application environment and identify and assess potential solutions for automating and streamlining regulatory and financial reporting processes. In addition, FBOs have to benchmark existing IT policies, procedures, and standards to the Federal Financial Institutions Examination Council (FFIEC) regulatory guidance, and remediate and formalize IT policies, procedures, and standards. Plus, existing controls and governance around data management may need to be further evaluated and enhanced to meet a higher level of demand for data quality and integrity.

Ready, set...

The Federal Reserve's unanimous vote approving the proposed rule started the clock on the comment period, which closes on March 31, 2013. It is seeking feedback from FBOs and other parties regarding how the rule, as proposed, are likely to affect them. After considering comments, the Federal Reserve could make changes to the proposed rule before finalizing it. For now, FBOs are looking at a July 1, 2015 deadline to become compliant.

Given the complexity of the requirements and the scope and breadth of changes needed, this is not a deadline that can be taken lightly. FBOs may not only need to make strategic decisions about their U.S. operations, but also may need to significantly alter their structure to conform to the new rule —forming an IHC, implementing a new governance structure and risk management controls, and much more. There are a host of other challenges that may await after structural changes have been made. FBOs will likely need to meet new capital and liquidity levels, upgrade the systems and processes that supply data for reporting and documentation purposes, and more.

All of which makes for quite a daunting to-do list. But at the same time, these goals may be eminently within reach. FBOs can't get started soon enough.

Appendix

Scoping considerations

Section	What requirements apply?	Global assets between $10B and $50B	Global assets $50B but U.S. assets < $50B	U.S. assets ≥ $50B
U.S. IHC	Required to form IHC, unless U.S. assets < $10B (excluding assets of U.S. branches and U.S. agencies)		✓	✓
Capital	Subject to U.S. capital requirements for BHCs and FBO must certify that it meets home-country capital standards that are broadly consistent with Basel capital standards, including Basel III.		✓	✓
	IHC is subject to U.S. advanced approaches capital rules or market risk capital rules if it crosses applicability thresholds, or if it elects, with Federal Reserve approval, to use the advanced approaches. IHC must submit annual capital plan to Federal Reserve if it has ≥ $50 billion in total consolidated assets.			✓
Stress testing	FBO must meet home-country stress test requirements in order to avoid U.S. asset maintenance and other requirements.	✓	✓	✓
	Federal Reserve's Dodd-Frank stress testing rules as if it were a U.S. BHC.		✓	✓
	FBO must meet additional conditions regarding home-country stress tests in order to avoid U.S. asset maintenance and other requirements.			✓
Liquidity	FBO must report results of annual internal liquidity stress test to Federal Reserve.		✓	✓
	Liquidity risk management and stress testing requirements. U.S. branch and agency network and IHC must maintain separate U.S. liquidity buffers.			✓
Counter-party limits	Limits apply to IHC and combined U.S. operations of FBO. Stricter limits apply to exposures between major counterparties.		✓	✓
Risk management	FBO must annually certify that it maintains a board level U.S. risk committee, which can be part of the overall risk committee of the board.	✓ *Only publicly traded companies FBOs*	✓	✓
	• Additional requirements for U.S. risk committee, at least one member of which must be independent • Must appoint a U.S. chief risk officer meeting certain requirements		✓	✓
Debt-to equity limits	New limits imposed if FSOC makes certain determinations about FBO's grave threat to U.S. financial stability.		✓	✓
Early remediation	Requirements apply, but not automatically subject to remediation actions upon exceeding an early remediation trigger		✓	
	Subject to nondiscretionary early remediation actions upon exceeding an early remediation trigger.			✓

Source: Deloitte & Touche LLP Analysis

Highlighted definitions in calculating thresholds[15]

Intercompany eliminations

U.S. intercompany transactions. The company may reduce its combined U.S. assets calculated by the amount corresponding to balances and transactions between the U.S. subsidiary or U.S. branch or U.S. agency and any other top-tier U.S. subsidiary or U.S. branch to the extent such items are not already eliminated in consolidation.

Subsidiary/definition of control

Consistent with the December 2011 proposal, a company is treated as a subsidiary when it is directly or indirectly controlled by another company. A company controls another company if it: (i) owns or controls with the power to vote 25 percent or more of a class of voting securities of the company; (ii) owns or controls 25 percent or more of the total equity of the company; or (iii) consolidates the company for financial reporting purposes. The proposed rule's definition of control differs from that in the Bank Holding Company Act and the Board's Regulation Y in order to provide a simpler, more objective definition of control.

Combined U.S. assets (excluding assets of U.S. branches and U.S. agencies)

Equal to the average of the total consolidated assets of each top-tier U.S. subsidiary of the FBO (excluding any Section 2(h)(2) company):

- For the four most recent consecutive quarters as reported by the FBO on its FR Y-7Q;
- If the FBO has not filed the FR Y-7Q for each of the four most recent consecutive quarters, for the most recent quarter or consecutive quarters as reported on FR Y-7Q; or
- If the FBO has not filed an FR Y-7Q, as determined under applicable accounting standards
- The FBO may reduce its "combined U.S. assets (excluding assets of U.S. branches and U.S. agencies) calculated above by the amount corresponding to any balances and transactions between any U.S. subsidiaries that would be eliminated in consolidation were an IHC already formed. Balances and transactions between any U.S. subsidiary, on the one hand, and the FBO's head office or other non-U.S. affiliate, on the other hand, would be included. For determining whether an FBO must establish a top-tier U.S. IHC.

FBO's total consolidated assets

Determined based on the average of the total assets:

- For the four most recent consecutive quarters as reported by the FBO on its FR Y-7Q;
- If the FBO has not filed the FR Y-7Q for each of the four most recent consecutive quarters, for the most recent quarter or consecutive quarters as reported on FR Y-7Q; or iIf the FBO has not yet filed an FR Y-7Q, as determined under applicable accounting standards.
- The \$10/\$50/\$500 billion asset thresholds for the following requirements: capital; liquidity; single counterparty credit limits; risk management; stress testing; and early remediation.

IHC's total consolidated assets

Determined based on the average of the total assets:

- For the four most recent consecutive quarters as reported by the IHC on its FR Y-9C;
- If the IHC has not filed the FR Y-9C for each of the four most recent consecutive quarters, for the most recent quarter or consecutive quarters as reported on FR Y-9C; or
- If the IHC has not yet filed an FR Y-9C, as determined under applicable accounting standards

U.S. total assets

Equal to the sum of:

- The average of the total assets of each U.S. branch and U.S. agency of the FBO:
- For the four most recent consecutive quarters as reported to the Federal Reserve on the FFIEC 002; or
- If the FBO has not filed the FFIEC 002 for a U.S. branch or U.S. agency for each of the four most recent consecutive quarters, for the most recent quarter or consecutive quarters as reported on the FFIEC 002; or
- If the FBO has not yet filed a FFIEC 002 for a U.S. branch or U.S. agency, as determined under applicable accounting standards.
- If an IHC has been established, the average of the "total consolidated assets" of the IHC, calculated as described above in this table.
- If an IHC has not been established, the average of the total consolidated assets of each top-tier U.S. subsidiary of the FBO (excluding any section 2(h)(2) company), calculated as described above in this table.
- The FBO may reduce its "combined U.S. assets" calculated above by the amount corresponding to balances and transactions between the U.S. subsidiary or U.S. branch or U.S. agency and any other top-tier U.S. subsidiary or U.S. branch or U.S. agency to the extent such items are not already eliminated in consolidation. Balances and transactions between any U.S. subsidiary, U.S. branch or U.S. agency, on the one hand, and the FBO's head office or other non-U.S. affiliate, on the other hand, would be included.

[15] http://federalreserve.gov/aboutthefed/boardmeetings/FBO_FR_notice_20121214.pdf

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