Deloitte.

Regulation W: The wall remains

Finding gateways to successful compliance

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What is Regulation W?

Federal Reserve Act sections 23A[1] and 23B,[2] and the implementation of Regulation W,[3] effectively erect a "wall" between Federal Deposit Insurance Corporation (FDIC)-insured depository institutions (IDIs) and their affiliates.[4]

Regulation W imposes capital-based quantitative and qualitative limitations on specified transactions, including IDI loans to affiliates, asset purchases from affiliates, purchases of securities issued by an affiliate, and other transactions involving the flow of "funding" from the IDI to the affiliate.

Regulation W also prevents IDIs from entering a service contract with an affiliate if the terms of that contract are less favorable to the IDI than "market terms" it would receive in similar transactions with unaffiliated third parties. These service and similar arrangements must meet specific Regulation W standards.

Regulation W's requirements are driven by an underlying policy to prevent US banking entities from transferring the benefits under US laws (including historically lower cost and stable FDIC-insured deposits) to affiliates that are not banks and, of course, are not subject to the same regime of US legal and regulatory requirements applicable to banks. Regulation W also prevents a nonbank affiliate—which may be a significant company in its own right—from using its position and economic power to abuse or take advantage of the IDI.

There are limited gateways (permitted affiliate transactions, exemptions) through Regulation W. In all cases, however, the regulation must be approached with great care, on a fully informed basis, following careful diligence and preparation, in accordance with tailored policies and procedures, and followed by continuing reporting, oversight, monitoring, and review.

Definition of an affiliate

In plain language, an "affiliate" of an IDI includes a variety of entities related to the bank, including:

- **Parent companies:** Any company that "controls" the bank, generally by owning or controlling a significant percentage of a class of the bank's voting shares.
- **Sister companies:** Any company that is directly or indirectly controlled by the same company that controls the bank.
- **Investment funds:** Any investment fund where an affiliate is an investment adviser.

What transactions are subject to 23A/ Regulation W capital-based limitations?

The following transaction types are subject to capital-based limitations, as well as other requirements:

- A loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase.
- A purchase of or an investment in securities issued by the affiliate.
- A purchase of assets from the affiliate (subject to limited exemptions).
- The acceptance of securities or other debt obligations issued by the affiliate as collateral security for a loan or extension of credit.
- The issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
- A transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.
- A derivative transaction, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.
- Attribution transactions: transaction with a third party where bank fund proceeds are used for the benefit of or transferred to an affiliate.

What transactions are subject to Regulation W, even where the transaction is not subject to the 23A/Regulation W capital limits?

The "arm's length," market terms requirement of 23B and Regulation W apply to all of the transaction types described above that are subject to the 23A capital-based limitations, as well as to the following types of transactions:

- The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase.
- The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise.
- Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person.

Why is Regulation W important today?

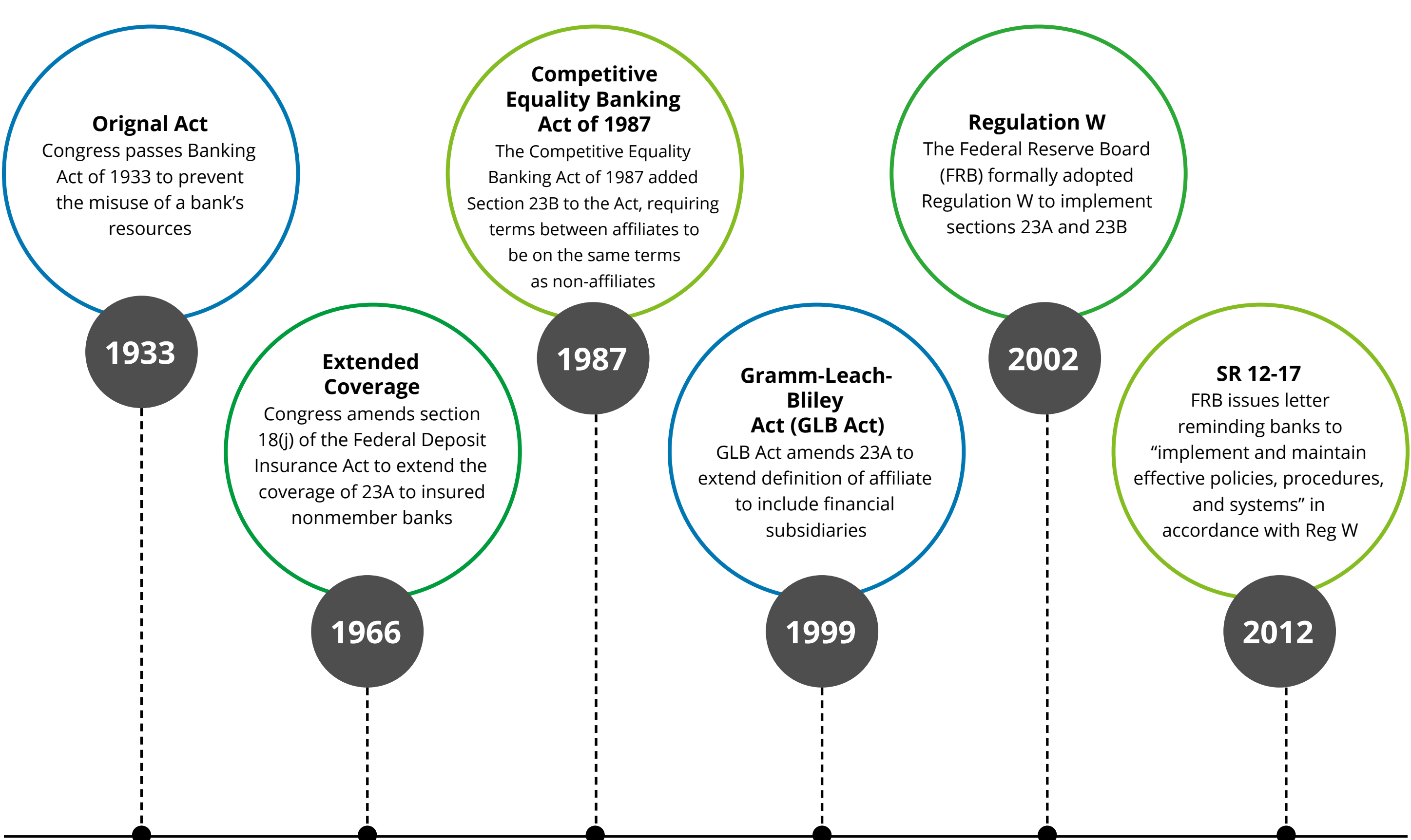
In the 20+ years since Regulation W was formally adopted in a regulation, there have been significant financial market disruptions (the global financial crisis), significant legislative and regulatory responses with huge industry impacts (the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations, including Regulation YY Enhanced Prudential Standards [EPS] for Bank Holding Companies and Foreign Banking Organizations [FBOs]),[5] and significant world events (global pandemic, and most recently the banking failures in early 2023). Throughout these periods of tumult and change, one thing has remained constant: the continuing existence and relevance of the Regulation W "wall" for banks, and the federal banking regulators' desire to maintain the necessity and "sanctity" of the banking charter and the unique capabilities that one brings.

Today, Regulation W questions and issues continue to be raised in a wide range of settings, including in connection with the following:

- Balance sheet optimization and booking model reviews performed by diversified financial services companies with significant US operations.
- Bank holding company and intermediate holding company (IHC) restructurings.
- De novo bank and US branch licensing applications and related business plans.
- Creation and launch of bank and IHC and subsidiary service companies.
- Revenue transfer agreements that are closely linked to booking model strategies.
- Service-level agreements between an IDI or US branch and an affiliate, whether the banking entity is the service provider or service recipient (for FBOs, parent companies may provide US operations and the IDI services due to efficiencies).
- Banking entity and affiliated nonbank entity employee dual hatting arrangements.
- Bank supervisory agency examinations and reviews, including related adverse Regulation W findings and related remediations.

Despite all the market and regulatory shifts, Regulation W has remained a supervisory priority and a foundational pillar of the banking regulatory system as we know it (see figure 1 below).[6] Banks must operate effective Regulation W enterprisewide compliance programs. Regulators have a heightened focus on protecting the depository institution and are limiting activities and driving improvements in risk management, compliance, and controls as a result. Regulators also expect greater transparency from banks, particularly when it comes to legal entity management and intercompany transactions. Since we first published on the importance of Regulation W compliance programs in 2018, regulators' expectations have increased the pressure on organizations to review their Regulation W compliance programs and explore alternatives to existing practices. These alternatives include the automation of controls and reporting. Banks are also expected to focus on preventive controls rather than overly relying on detective controls to better demonstrate that sustainable governance and control frameworks can scale Regulation W compliance controls.

Figure 1: History and background of Regulation W[7]



Regulation W challenges

Compliance with Regulation W across a complex legal entity structure has been, and remains, difficult for many banks. Banks' challenges with Regulation W can be exacerbated when the enterprise strategy includes any of the following:

- Expansion of capital market activities.
- Holding company and service company restructuring.
- Market and other pressures on capital and liquidity.
- Pressure to rationalize or streamline operations, including following mergers and acquisitions.
- Changes to service models and the related buildout of centralized service centers and service companies for resolvability purposes.
- Demands to achieve business efficiencies.

Regulation W is a critical regulatory requirement that requires banks to continually review and recalibrate their related compliance programs to keep pace with the challenges and changes described above. It is now time for banks to review, streamline, and automate preventive and detective controls for affiliate transactions. At the enterprise level, ownership, governance, and policy design are more critical than ever.

Understanding how Regulation W can impact mergers and acquisitions (M&A) and business model transactions is fundamental to business strategy. See Business and Entity Transformation.

Designing, assessing and transforming the processes, controls, and infrastructure is central to standing up an effective Regulation W compliance program. See Regulatory Risk and Compliance Services.

Some challenges with Regulation W and related compliance programs

In our experience, banks have typically faced the following challenges, and alleviating these pressure points may help modernize compliance programs to meet current expectations:

- De-centralized or lack of an end-to-end awareness of regulatory requirements across business and support/control units—particularly technical provisions, such as exemptions, attribution rule, and market terms.
- Lack of bank entity-specific Regulation W policies, controls, and reporting for each entity (e.g., a branch, an IDI) that is stand-alone but includes Combined US Operations (CUSO)/IHC/enterprise escalation and roll-up reporting.
- Inaccurate, incomplete, and/or lack of affiliate lists and inadequate processes to identify affiliate transactions (according to Regulation W's definition) within risk, financial, and underlying transaction systems; along with gaps in legal entity reporting and looking across compliance requirements that overlap.
- Outdated or incomplete policies, and limited procedures that do not provide end-to-end transactional guidance or control expectations specific to Regulation W, across all businesses, functions, and entities, including the investment bank and front office.
- Lack of appropriate documentation and evidence to substantiate 23A exemption usage and 23B market terms requirements.
- Moving interpretations of core elements of Regulation W, such as covering attribution rules and 10/20 limits.
- Control infrastructure that is highly manual and detective in nature and does not implement trade date (T) or T+1 reporting and preventive controls regarding Regulation W.
- Lack of corporate compliance programs and defined compliance monitoring and testing programs that are also not aligned to appropriate controls.
- Limited capture of Regulation W risks in the corporate risk and control self-assessment (RCSA) analysis and/or documentation.
- Inadequate monitoring of intraday credit and derivatives for affiliates.
- Limited processes that support derivative transactions, including collateral requirements.
- Outdated/nonexistent service-level agreements and insufficient pricing methodologies to support charges.
- Ineffective training programs across business and support functions.
- Overreliance on business certifications that do not have the appropriate substantiation to show compliance with Regulation W.
- Inadequate internal audit review programs and testing to determine the level of inherent risk of Regulation W and its technical aspects.

Challenges in implementing Regulation W Compliance Programs

Before a bank can design an appropriate Regulation W compliance program that can appropriately mitigate the risks associated with affiliate transactions through well-designed internal controls and processes, it is very important to conduct a proper analysis of the regulatory requirements and their applicability to the organization's business transactions and products.

This is one of the primary areas in which the regulators have identified failures and issues with Regulation W compliance programs, as banking entities and supporting legal entity structures become increasingly complex.

We have observed the following challenges with some banks implementing their Regulation W compliance programs:

- **Knowing the technical requirements:** Limited knowledge of the regulatory requirements across businesses and functions.
- **Analyzing the application of the regulation across the business:** Lack of analysis conducted of the regulatory requirements and how they apply to specific business products and transactions. For example, many organizations have controls that only cover the traditional "banking product side" of a banking entity, and do not cover the trading or investment banking transactions within the bank and where covered transactions are very likely to arise.
- **Knowing requirements that require documentation:** Lack of sufficient analysis on the 23A exemptions and how an organization qualifies for them, and then insufficient evidence and support for the usage of the exemptions.
- **Knowing your pricing:** Have the appropriate linkage between 23B "fair market terms or arm's length" versus standards applied for transfer pricing (these terms are very high level in the regulation and require more specific definition by an organization, given the methodology, and how to show this can vary significantly for liquid versus complex or structured products products and transactions). 23B pricing needs to "stand alone" and pass scrutiny per the good faith standards.
- **Knowing your affiliates:** Incomplete affiliate list that is highly manual with lack of appropriate governance and defined roles and responsibilities.
- **Training the business:** Providing inadequate training to businesses and functions that are outdated with the growing complexity of the entity.

Designing an effective Regulation W compliance program—seven components

Designing an appropriate Regulation W compliance program is highly dependent on having an thorough understanding and analysis of the requirements for your organization. Please refer to the "What is Regulation W?" and "Navigating Regulation W technical complexity" sections for more details and information related to key requirements within the regulation and how to appropriately consider them in your analysis.

The framework illustrated in the figure 2 is one that banks can consider when implementing a robust Regulation W compliance program.

Figure 2: Recommended Regulation W compliance program

Risk assessment
Governance
Policies and procedures
Regulatory reporting
Technology enablement
Monitoring and testing
Training
Core Regulation W requirements
Section 23A analysis
Regulation W affiliate list management
Section 23B market terms
Applied core risk management components

Core Regulation W requirements

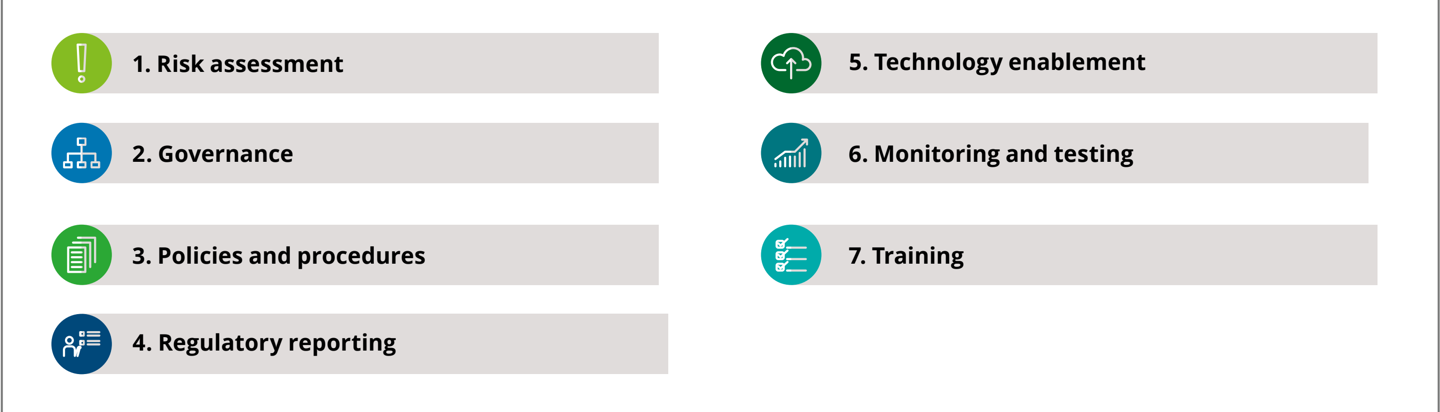
These are the critical regulatory requirements and analysis that define the applicability of the requirements to an organization and drive the Regulation W compliance program design and implementation.

Applied core risk management components

These are the aspects of a Regulation W compliance program that are built and tailored around the Regulation W applicable activity and are foundational for a regulatory, enterprisewide compliance program.

A robust Regulation W compliance program is anchored in the center by the regulatory requirements that must be met—including an analysis of the requirements, their applicability to an organization's specific business, and transactions and strategic decisions on the exemptions an organization chooses to leverage against the quantitative requirements. On the outer ring are the seven core components (figure 3) that are recommended for a strong compliance program:

Figure 3: Applied core risk management components



We will explore each of the elements below and provide considerations based on our industry perspectives.

Risk assessment

Regulation W should be included in the second line's risk assessment process. Based on recent observations and regulatory feedback, the risk assessment should be grounded in the detailed regulatory requirements and supported by a more granular applicability or risk assessment, which further demonstrates the Regulation W risk by business or function. For example, noting Regulation W at a macro level as "high" or "low" risk without any support and documentation to demonstrate the risk by legal entity, business, or function may be challenged by regulators and internal auditors, compliance, and other reviewers of the program. The regulation requirements should be parsed in the risk assessment for ease of control establishment, monitoring, and testing of compliance.

In addition, Regulation W should be included in the risk assessment process conducted by the first line (i.e., risk and control self-assessment process) and should indicate the risk to its specific LOB/ function for the activities under its remit.

The goal is to determine the inherent risk, risk mitigants, adequacy of internal control framework, and residual risk that remains to be managed and controlled.

Based on the assessment of risk, this should drive the first line's monitoring and testing control program. In addition, it can assist in determining the second line's oversight.

Key takeaways: Risk assessment

- Map and incorporate Regulation W requirements into the Risk assessment program.
- Determine completeness of Regulation W requirements applied to business and control functions.
- Apply consistent compliance risk assessments to business segments and support functions.
- Create a common understanding of the types and nature of transactions with Regulation W implications from an inherent risk perspective.

Governance

A robust governance framework is the cornerstone of an effective compliance program. Banking leaders should understand critical terms embedded within the regulation in light of the context of their institution's legal entity structure, product offerings, and control structure, as noted in the "What is Regulation W?" section. Banking leaders should be able to answer the following questions, tailored to the specifics of their organization:

- What constitutes an affiliate, given that it may be different from financial intercompany consolidation entities?
- Who owns the affiliate list, and how will affiliates be captured and reported? Has the affiliate list been appropriately analyzed to determine its completeness and overall accuracy?
- What types of covered transactions are conducted by a bank holding company and its businesses? If a business conducts transactions with an affiliate, what process is in place to determine if it is a covered transaction?
- What are the internal policies of conducting covered transactions? How are individual transactions aggregated across businesses for the purposes of compliance with the quantitative limits? How will these be monitored and reported by the business and aggregated by control functions? Who will do this work?
- What collateral requirements apply to an affiliate? How will collateral be allocated, monitored, and reported?
- What transactions are exempt from Section 23A? Who identifies these? How are they captured, monitored, and reported?
- Who determines how to value a covered transaction? Which methodology is used to determine value?
- How are intercompany agreements maintained? How are revenue and expenses charged, cleared and settled, and monitored for payment?
- How does Regulation W monitoring and reporting roll up from each entity to CUSO, IHC, and enterprise?

Good governance also enables banks to respond to regulatory requests and actions swiftly and effectively. This capability will likely be largely determined by the institution's organizational control structure. Is it centralized or decentralized? Who is the Regulation W policy owner? What other roles and responsibilities need to be attributed across the three lines model? What is the nature of the interaction between the depository institution and other entities under the affiliate definition?

Under a centralized structure, a few central functions share accountability. In a decentralized arrangement, accountability is spread across the institution. A decentralized approach may be more challenging because individuals could treat same or similar transactions in different ways, and there is the potential for control duplication and/or gaps. Given that Regulation W must be aggregated end-to-end to demonstrate the controls across the entity and how they meet the regulatory requirements, a decentralized approach that is siloed across businesses and functions is likely to pose significant challenges to an organization. The aggregate and holistic nature of Regulation W requirements has driven many banks to revert to more centralized operating models, with ownership and roles and responsibilities across the three lines model clearly outlined.

Many banks are asking the key question regarding Regulation W ownership. By ownership, we mean the Regulation W policy owner or "quarterback" of the enterprisewide process and controls—not necessarily a single person or function that would own it in totality. This person or function would own the policy that outlines an institution's compliance risk appetite and framework for Regulation W. Should it be finance, compliance, front office/business, operations/chief operating officer (COO), or another control function? We have observed many of these options across both domestic banking organizations and FBOs. The decision can depend on various factors such as the current process and infrastructure, the legal entity structure, and the breadth and depth of Regulation W-covered transactions across the organization.

Organizations should also consider management-level committees and where Regulation W violations and issues can be reviewed. Generally, these committees are cross-functional and include representation from across the business and control functions and can be stand-alone or part of existing risk, regulatory, and legal entity management committees, with the issues reported to these committees included in reporting made to the board of directors. Whichever approach and ownership model a bank chooses, leaders should define the role, responsibility, and authority for each line of business (LOB), function and board, and confirm that the regulation is implemented and enforced in a consistent and transparent way. Plus, each LOB function should have controls that are transparent, documented, monitored, and tested.

Today, the most effective risk management processes are likely to have the three lines model. This means relevant individuals must understand their role, their responsibility, and their connection to the process steps for every transaction. This system of governance should lead to robust management and board reporting—as it is applied to Regulation W and its requirements.

First line: Line of business

A bank's LOBs, which initiate and execute transactions, compose the first line. The LOBs should verify that appropriate controls are in place to comply with the regulation and differentiate between detective and preventive controls. They are required to "know your affiliate"—especially for businesses with structured transactions and complex intercompany relationships. LOBs should understand how transactions may trigger Section 23A and 23B requirements, and Regulation W, and have appropriate management reporting that is reviewed on a regular and frequent basis. When LOBs have their own risk and control personnel, banks should create a compliance framework that differentiates the roles between LOB compliance and corporate compliance.

Second line: Corporate compliance organization

The bank's corporate compliance group may develop and own the policy that outlines an institution's compliance risk appetite and framework for Regulation W. As noted earlier, this could vary in some organizations if the ownership resides with finance or another function. Regardless of its role as policy owner, corporate compliance serves as the second line. It should provide an inventory of the regulatory requirements, mapping of the applicability of those requirements to the LOBs and control functions, overseeing compliance risk, and monitoring transactions within each legal entity.

In addition, corporate compliance establishes the oversight program, which includes all the relevant components of a compliance program.

- Credit risk, which grants credit approval for counterparties, including affiliate counterparties, and monitors for credit exposure.
- Treasury, which allocates the collateral pool and monitors its levels.
- Finance, which sets capital limits and monitors positions. In addition, finance establishes cost allocation methodology, and establishes market terms guidance.

Third line: Internal audit

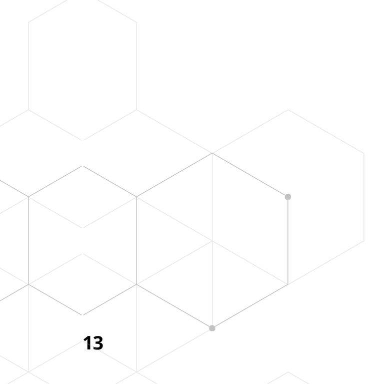
Internal auditors validate the structure of the program and test the effectiveness within the LOBs and corporate compliance functions. Internal auditors should perform comprehensive scheduled testing, which includes assessing compliance with laws and regulations as well as internal policies and procedures. Testing and monitoring performed through internal audits would be separate from those performed by corporate compliance on a more routine basis.

As part of their oversight, internal auditors would need to confirm they have the appropriate understanding of Regulation W requirements and then link their testing and validation to the institution's controls across the first and second lines and across different legal entities within the bank. Additionally, they would need to link their knowledge of key controls in other corporate functions, such as credit risk and finance, which have an impact on affiliate transactions involving the bank.

Key takeaways: Governance

- Formalize roles and responsibilities for enterprisewide Regulation W compliance across the three lines model.
- Consider that an aggregated and end-to-end view of Regulation W compliance for the organization is required and therefore siloed business and function models may pose significant challenges.
- Don't forget key functions that should be included in the end-to-end process framework for Regulation W such as treasury, credit, finance, legal, compliance, and others.
- Designate a management committee with sufficient stature and ability to resolve Regulation W violations and issues.

Given that Regulation W must be aggregated end-to-end to demonstrate the controls across the entity and how they meet the regulatory requirements, a decentralized approach that is siloed across businesses and functions is likely to pose significant challenges to an organization.



Policies and procedures

Every banking organization should have a documented and approved Regulation W policy regardless of whether the bank has applicable covered transaction activity. The policy should be enterprisewide and should not be siloed to cover only the bank or a single line of business or function. Additionally, each entity of the bank should have independent Regulation W policy coverage, highlighting the entity's approach to Regulation W compliance as well as how it rolls up to the holding company's policy and procedures.

The policy should outline the regulatory requirements, applicability to the organization, and roles and responsibilities across the three lines model framework. Some of the roles, which the policy may articulate, include:

- Board and senior management awareness, monitoring, and oversight (due to far-reaching implications) across the organization—which includes the bank and its affiliates as part of a bank holding company structure—and with a particular emphasis on the sanctity of the depository institution.
- A management committee that allows for issue escalation and resolution, policy approval, and strategic decisions.
- An officer or function that "owns the Regulation W policy" and is accountable for an enterprisewide Regulation W compliance framework oversight.
- Clear roles and responsibilities among first, second, and third lines, inclusive of significant legal entities. Key functions to consider in the framework are treasury, credit, regulatory reporting, finance, compliance, front office/business, technology/operations, bank regulatory legal, and legal entity management/corporate secretary.

In addition to the enterprisewide policy, there should be documented procedures and standards, which implement the policy at the LOB level for each process step owner for each entity involved in the Reg W compliance program.

Key takeaways: Policies and procedures

- A documented and approved (board, management committees) Regulation W policy should be required regardless of activity.
- The policy must be enterprisewide and applicable to all functions/ LOBs, while highlighting how entity-specific reporting rolls up to an enterprisewide view.
- An owner of the policy should be established.
- The policy should clearly outline the risk appetite and roles and responsibilities for compliance across the organization.
- Detailed procedures should be established for each function/LOB in the policy to implement the standards and requirements.

Regulatory reporting

In creating a compliance framework, banks should consider how they capture data, generate information, and communicate issues and findings to the board, executives, regulators, and other stakeholders.

Institutions should establish a formal reporting and communications structure not just to confirm that relevant stakeholders are receiving appropriate and timely information, but also to meet regulators' expectations. This structure should highlight how each legal entity has its own reporting and communications structure internally highlighting escalation procedures, as well as how each legal entity rolls up for an enterprise-level view.

Some common measures that institutions can consider when evaluating Regulation W risk within LOBs or control functions include the following:

- Overall transaction volume and stated transaction volume with affiliates.
- Extent of the use of exemptions.
- Volume of covered transactions (both transaction volume and dollar value).
- Complexity of covered transactions.
- Use of intercompany agreements (reviewed to determine consistency in issues such as cost methodology and arm's-length transacting).
- Collateral composition and requirements.
- Extent of derivative transactions.
- Intra-day, daily, monthly, and quarterly reporting to management on 10%/20% limits monitoring.
- Board reporting that effectively communicates revenue arrangements and service-level agreements and the income/expense impacts of both.

When developing management-level reporting, banks should consider the timeliness of the reporting and data and push to gather information on transaction/trade date (T) or T+1. Reporting and associated controls past this period can be viewed as insufficient at mitigating the appropriate Regulation W risk.

In addition to management and board reporting, there are also requirements for regulatory reporting on a quarterly basis—the FR Y-8 report. This report collects information on transactions between an insured depository institution and its affiliates that are subject to Section 23A requirements. The FRB uses this information to enhance its ability to monitor bank exposures to affiliates and facilitate Section 23A compliance.

For these formal FR Y-8 regulatory filings, banks should apply regulatory reporting control frameworks and leading industry practices with end-to-end accountability defined; front-to-back and back-to-front testing of data; and a process to support reporting completeness, timeliness, and accuracy. Banks should implement robust reporting processes that use downstream and upstream risk and financial systems to support an "affiliate view" of a depository institution's books and records. For instance, risk and financial systems should appropriately report Section 23A transactions, including the level of covered transactions, the collateral required to support them, and the outstanding exposure against the quantitative limits. Many banks have also created affiliate systems and registers that pull information from all source systems centrally for Regulation W tracking and reporting of all transactions. The process, or where and how exemptions will be applied to covered transactions, should also be appropriately evaluated within the end-to-end process.

In addition, there is an opportunity for banks to review and optimize their broader legal entity reporting. Depending upon the legal entity structure and headquarters of the parent bank, several different reporting forms are used as event-driven reporting to identify legal entities and associated information. This includes their purpose and type of legal form for compliance with laws and their implementing regulations, including Dodd-Frank Act, Gramm-Leach-Bliley Act, Sarbanes-Oxley Act, Bank Holding Companies and Change in Bank Control (Regulation Y), Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations (Regulation YY), and Resolution Plans Required (Regulation QQ).[8] There is commonality and an integration required between the Regulation W affiliates, for example, to the merchant banking rules as part of Regulation Y and some common tracking and data across the FR Y-10, FR Y-8, and FR Y-12 reporting. Therefore, it is important that banks understand the reporting requirements across their legal entity structure reporting and look at "converged" requirements.

For those banks that can do this, it is a significant opportunity for increased efficiency, effectiveness, and transparency across regulatory reporting processes, including Regulation W.

Key takeaways: Regulatory reporting

- Deliver consistent and regularly scheduled enterprisewide reporting to management and the board, proving that compliance issues are aggregated, tracked, and escalated for resolution.
- Consider the timeliness of the data and information used in management-level reporting.
- Identify triggers for escalation, and/or to flag potential issues, and report accordingly within and across legal entities.
- Communicate regular results of Regulation W monitoring and testing within the organization.
- Centralize Section 23B reporting to track service-level agreements and intercompany receivables and payables.
- Confirm that current management information system (MIS) reporting is appropriately scaled to the risk profile of the organization and that it provides a clear view into credit exposures with the required collateralization across the enterprise for both loans and derivatives.
- Verify that reporting frequency and oversight is commensurate with the number and types of transactions.
- Determine how manual the reporting processes are to assess if there are opportunities to automate portions of the reporting process.
- Consider the synergies and linkages across various legal entity structure reporting and the underlying data used to identify additional optimization opportunities in regulatory reporting processes.
- Streamline automated reporting for each bank's financial reporting that is able to identify and report affiliate-related transactions against an affiliate list for each banking entity.

Technology enablement

Many banks have recently been focused on investing in technology, infrastructure, and automation for Regulation W controls. We've found banks' technology to be highly manual, and in our experience working with clients, regulators appear to be (1) demanding increased focus on streamlining the end-to-end process; (2) linking the affiliate list to financial, credit, and front-office systems; (3) developing automated and timely management reporting; and (4) increasing automation of internal controls with an increased focus on preventive controls (where possible) versus overreliance on delayed detective controls. With the linkage of Regulation W to legal entity management, risk management, booking model, the Volcker Rule,[9] recovery and resolution planning, transfer pricing, and many other areas that affect the bank and its affiliates, investment in technology is almost deemed necessary, especially if banks want to continue to grow revenue and reduce internal costs and redundancies. Considering the synergies of the Regulation W process and controls with other regulatory requirements, this not only can support greater efficiency across the enterprisewide control framework, but also can be used by banks to support internal use cases and budgets for increased investment in technology and controls. Isn't it time for Regulation W to have automated and preventive controls scaled to the business?

Many banks have institution-applied risk and finance IT systems that can be enhanced to accommodate and effectively capture transaction activity, including affiliate identification, exemption applicability, collateral requirements, quantitative limits, and reconcilement of Section 23B service fees.

A bank should provide an appropriate level of automation, as discussed earlier, but should scale it to its risk profile based on transaction or product type and volumes and analyze the linkage to other bank processes and controls. For example, simple enhancements to trading systems with affiliate identifiers and collateral flag requirements can help with overall control and oversight of compliance. Other enhancements can consider affiliate flags in legal entity systems, increased real-time 23B analysis and saving of transaction data, and Regulation W transaction warehouses or aggregator systems that allow for easier review and reporting.

Other banks with greater volume of transactions and complexity may want to consider more preventive control solutions leveraging some of the new cognitive technology available—such as central rules decision logic, which can be automatically connected to work alongside real-time trade flow and financial and regulatory reporting systems versus hard coding of controls in numerous front-office systems, or artificial intelligence-driven controls that can identify and review covered transactions quickly.

Given the overall trend in the banking industry to look for increased effectiveness and efficiency to enable growth, and with all the new technologies available from robotics to cognitive techniques, there are many more options available for banks to consider.[10]

Key takeaways: Technology enablement

- Identify Regulation W processes that are embedded in many risk, finance, and underlying transaction systems.
- Determine end-to-end process flows that show handoffs for key processes across business and support functions.
- Maintain an ongoing and centralized repository of key Regulation W information, including a complete and accurate affiliate list, covered transactions, collateral requirements, exemptions and type of exemptions, and quantitative limits.
- Automate key risk monitoring reports (collateral and 10% and 20% limits) for level of capacity.
- Consider an appropriate balance of preventative and detective controls based on complexity of processes and volume of transactions and activity.
- Leverage synergies with other regulatory requirements to build a broader use case for automation within the organization.

Monitoring and testing

A critical component of a bank's compliance program is likely to be the monitoring and testing of transactions, as well as the effectiveness of controls. Controls would include the following:

- Identification of an affiliate through an affiliate list.
- Identification of covered transactions by tagging affiliate transactions in financial, credit, collateral systems, or other related transaction systems.
- Linkage of controls to enterprise inventories and libraries of applicable laws and regulations.
- Review of flagged transactions prior to execution.
- Assignment of collateral, if appropriate.
- Monitoring of collateral requirements.
- Pre-emptive review of collateral types prior to execution of transaction.
- Quantitative limits and market terms valuations.
- Pricing execution for intercompany agreements.
- Diligence reviews prior to loan approvals to identify attribution transactions.
- Intra-day, daily, monthly, and quarterly reporting to management to monitor 10% and 20% limits.

The testing and monitoring program should be designed based on the institution's organizational structure and should reflect the standards established by corporate compliance for risk assessments.

Several of the previously mentioned functions have their own controls and processes, which may be internal to their functional checks and balances. For example, regarding market terms requirements or Section 23B requirements for service fees, finance at the LOB and corporate levels may have established front-to-back, and back-to-front, processes for the recording and reconciliation of receipts to the general ledger.

In addition to implementing effective detective controls to review transactions after the fact, leading practices also include implementing automated preventive Regulation W controls. The implementation of preventive automated controls is often based on the maturity of an entity's automation and systems. These preventive controls flag transactions before they are completed and subjected to subsequent detective reviews. This combination of advance preventive and after-the-fact detective controls can be especially effective in helping institutions avoid falling into non-compliance with Regulation W.

In either a decentralized or centralized institution, corporate compliance should be performing independent monitoring and testing as the second line and should base its assessment of the state of compliance on the effectiveness of the first line's testing and monitoring program. For corporate compliance to form its independent view of the consolidated compliance risk profile across the institution for Regulation W, it should also consider changes to key controls and the institution's strategy for affiliate transactions. Separately, but equally important to consider, are external factors such as regulatory agency examinations, as well as proposed regulations by individual regulatory agencies and their prospective impact to the institution. This independent monitoring and testing can help confirm that the risk assessment process is being appropriately applied and that the monitoring and testing program is effective and sustainable.

The mix of testing versus monitoring typically varies across legal entities, based upon the inherent risk and the effectiveness of control points, which results in residual risk rating. LOBs and control functions with strong testing results may eventually be subject to less frequent testing and instead need regular monitoring. Extensive testing and monitoring may be appropriate for high-risk or error-prone areas. Regardless, independent compliance should be achieved by some type of assurance review by the first line, combined with reviews by the second and third lines as needed.

Key takeaways: Monitoring and testing

- Provide ongoing, periodic monitoring and comprehensive escalation processes for Regulation W.
- Formalize accountability across LOBs and support functions aligned to both preventive and detective controls.
- Determine if the scope and frequency of monitoring and testing is sufficient.
- Track intercompany agreements and provide adequate documentation to evidence market standards, payment settlements, and reconciliation of receivables and payables on a timely basis.
- Effectively document and flag credit processes for credit approvals (Section 23A) in credit systems as affiliate transactions.
- Confirm collateral monitoring is comprehensive and not fragmented across different groups.
- Determine the adequacy of the control framework, paying close attention to the completeness of controls across the first LOB.

Training

Banks should consider providing robust training beyond simply meeting Regulation W requirements. This training could include knowledge and understanding around their particular systems, policies, and processes.

As a result, functional stakeholders should not only know their role within the process, but should understand that failure at any point could mean noncompliance with the regulation. In this regard, training is used to communicate accountability and responsibility across an organization.

Effective training also involves collaboration among the various risk and control functions of the various LOBs and the engagement of previously mentioned functions throughout the life cycle of the transaction.

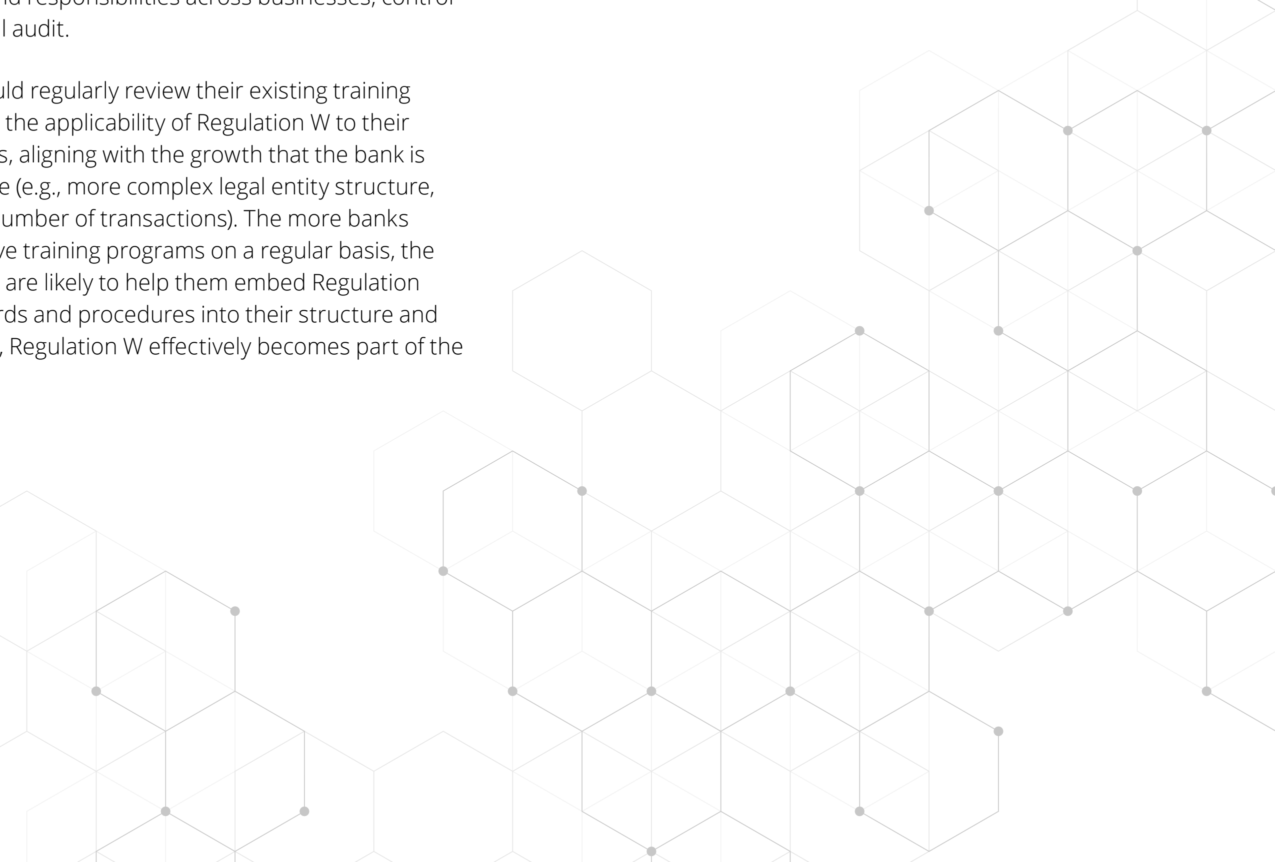
Training can also help address the lack of adequate institutional knowledge of Regulation W requirements and how they should be applied within the business, compliance, and internal audit areas. Even if this knowledge does exist in banks, it typically resides with their regulatory and legal divisions and may not always be communicated across the enterprise. This usually results in LOBs having inadequate controls. Several detective and preventive measures can help mitigate this concern, but training is a fundamental component of a well-designed and comprehensive Regulation W program. Training programs should not only provide baseline Regulation W awareness, but also target instruction that is aligned with roles and responsibilities across businesses, control functions, and internal audit.

Over time, banks should regularly review their existing training programs and refresh the applicability of Regulation W to their individual legal entities, aligning with the growth that the bank is experiencing over time (e.g., more complex legal entity structure, managing increased number of transactions). The more banks provide comprehensive training programs on a regular basis, the more those programs are likely to help them embed Regulation W compliance standards and procedures into their structure and processes. As a result, Regulation W effectively becomes part of the institution's culture.

Consequently, training is often conducted in two parts: (1) baseline training that explains how to apply Regulation W and provides information about the institution's policy to a wide audience, and (2) more customized training to specific LOBs and support/control functions.

Key takeaways: Training

- Analyze training needs on an enterprisewide basis, so relevant training can be developed and provided at regular intervals (or provided regularly).
- Provide comprehensive training on a regular basis to defined groups that own key controls and update training material over time.
- Document, track, and monitor Regulation W training objectives, and confirm that priorities are being achieved.
- Include compliance training requirements in annual employee learning and performance goals, particularly for those key control owners of Regulation W.



Navigating Regulation W technical complexity

The complexity of Regulation W is driven by its broad application across products, LOBs, and control functions throughout the organization. Institutions should focus their resources and attention on several key technical areas, due both to their importance and the challenges they typically present. In this section, we have identified some of these areas and have included thoughts on how to achieve them to ease the path to Regulation W compliance. As we mentioned earlier, without appropriately understanding the technical requirements and how they apply to an organization, a bank will likely be challenged to design an effective and efficient Regulation W compliance program.

The affiliate list

In complying with Regulation W, banks should maintain an accurate and complete list of entities that qualify as affiliates. But this is challenging for many, in part because several areas can create an entity, which would be deemed as a Regulation W affiliate under the rule. Banks face other challenges developing an affiliate list as well, some of which include:

- Absence of robust governance processes.
- Lack of clearly defined roles, responsibilities, and control processes for preapproving such entities.
- Lack of systematic assignment of unique entity identifiers, which flag affiliates and allow credit exposure between the bank and its affiliates to be automatically captured.
- Lack of systematic processes for searching, updating, and disseminating the affiliate list to the front office and control functions.
- Extensive use of manual processes and lack of centralized systems, which can lead to errors and inconsistent updating.

Before a transaction is complete, it is essential to know whether it occurs between a bank or its subsidiaries and an affiliate, and, if so, under what conditions the transaction would be permissible. A complete and accurate affiliate list, along with a "know your affiliate" culture is important in this regard. A formal governance process covering affiliate creation, maintenance, and approval responsibilities

documented in a responsibility assignment matrix (RACI) and procedure, unique data identifiers, automated updating processes, and the timely dissemination of the updated list and the ability to easily query the affiliate list can also help achieve this objective.

Many banks have chosen to leverage their legal entity management systems, processes, and people to also manage and control the Regulation W affiliate list. This is considered a leading practice so that banks do not create multiple legal entity masters. Regulation W affiliates can be flagged or specifically identified within these broader legal entity management systems for more enterprisewide control and risk mitigation. Automation will likely be key going forward and to answer the following questions: How can affiliates be flagged early in the client onboarding process? How can affiliate lists be embedded in first line and financial systems to streamline monitoring and testing?

Potential covered transactions

Identifying potential covered transactions is a fundamental part of understanding and building a comprehensive Regulation W compliance program. In many organizations, the LOBs are responsible for determining “covered transactions.” Procedures for identifying and monitoring covered transactions may vary across business units. The mechanism for reporting such transactions can often be manually driven (for example, using a spreadsheet can lead to potential errors).

A challenge is to define enterprisewide standards, standardized processes, and reporting and monitoring procedures to verify the accurate identification, capture, and treatment of covered transactions throughout the transaction life cycle.

While LOBs, as the first line, should typically identify potential covered transactions, control functions (as the second line) should establish clear requirements regarding the information needed from LOBs, monitor whether the information is received, and conduct the assessment and activities under their remit.

Collateral monitoring

Regulation W requires banks to verify that each of their credit transactions with an affiliate are secured by collateral. The regulation specifies the amounts of collateral required—ranging from 100% to 130% of the market value of the transaction based on the type of collateral posted. For example, using cash or US government obligations as collateral can be posted at 100% of the market value of the transaction, while using stock or real estate as collateral would require it to be posted at 130%.

Another Regulation W requirement for collateral states is that a deposit account with the bank that is used for securing credit transactions between the bank and its affiliate must be segregated, earmarked, and identified for the sole purpose of securing such transactions.

There are also limitations on the type of collateral that can be used for securing credit transactions with affiliates (for example, low-quality assets, securities issued by an affiliate, and others are considered ineligible). Plus, eligible collateral must meet certain perfection and priority requirements.

Given the specificity of the collateral requirements and also the continuous collateral maintenance requirements specified under the Dodd-Frank Act, some institutions may have difficulty in confirming that the appropriate amount and type of collateral are posted for all covered transactions on an ongoing basis. It is helpful to develop the capability and controls to monitor the amount and type of collateral posted relative to the covered transaction, and then appropriately increase the amount of the collateral if it diminishes in value or release the collateral once the transaction rolls off. This means institutions should have tight and well-controlled collateral processes, policies, and procedures in place. Central management of the collateral requirements generally works most effectively in practice.

Exemptions

The use of exemptions has been an area of focus in past and recent horizontal exams conducted by banking regulators. At the heart of the issue is how banks have determined whether a transaction qualifies for an exemption and whether sufficient analysis has been conducted and documentation retained to support the use of the exemption. If an exemption is misapplied or there’s insufficient documentation to support the use of the exemption, the transaction would likely become a covered transaction subject to Section 23A quantitative and collateral requirements.

Fundamental to the use of exemptions is a robust process for identifying whether a transaction with a Regulation W affiliate can be transacted under the particular exemption. In this regard, the organization should define procedures that would outline available exemptions, key questions or attributes that the business line or unit can use to help determine whether a transaction is eligible for exemption, and documentation requirements for its use.

For example, the intraday credit exemption requires the following:

- Policies and procedures to identify intraday exposures with affiliates and to monitor transactions that give rise to intraday credit exposure.
- Monitoring intraday exposures that roll off by the end of the day. If that's not the case, then they must be identified and treated as covered transactions subject to Section 23A collateral requirements and/or quantitative limits.
- Escalation processes for overdrafts that are anticipated to exceed intraday limits and/or are not cleared by the end of the day for an affiliate or group of affiliates (which then could become a covered transaction).

Attribution rule

Under Regulation W, the attribution rule states that any bank transaction with any person is deemed an affiliate transaction subject to Section 23A to the extent that the proceeds from the transaction are used for the benefit of, or transferred to, an affiliate. However, determining the intent of the person or third party during the transaction on whether the proceeds will be used for the benefit of, or transferred to, an affiliate is quite challenging. It puts additional pressure on the front office and control functions to determine potential uses of funds/proceeds extended to third parties.

Establishing controls before a transaction is completed helps identify transactions with the potential for attribution. They typically include the following:

- An approval process that analyzes whether a newly designed product is used for its intended purpose and if it will have any funds benefiting an affiliate.
- Credit review of an extension of new funds to assess the potential uses of funds and whether the purpose of the transaction is to extend a fund to benefit an affiliate.
- Account transaction or product reviews to understand how funds are used throughout the life of the transaction.
- Including terms in the loan agreement prohibiting the use of funds to make payments to an affiliate, including purchasing an asset from an affiliate or payment of an obligation owed to an affiliate.

Section 23B requirements: Market terms

Under Regulation W, a bank may not engage in a transaction unless the transaction is on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with or involving non-affiliates. In the absence of comparable transactions, the transaction should be based on terms and under circumstances including credit standards that would be offered in good faith or would apply to non-affiliates.

The market terms requirement applies to virtually all products offered to an affiliate, including extensions of credit, loans, the purchase of assets, and borrowing or selling securities or assets. It also applies to the provision of services to affiliates (discussed further in the following section). Transactions requiring market terms should be supported by a market terms analysis, which can involve comparison of the terms, conditions, and pricing of the transactions relative to similar non-affiliate transactions or external pricing studies.

Many banks implement Regulation W policy and related procedures that enumerate key non-price contractual terms and conditions (as examples, items like termination, indemnification, reps, warranties, governing law, dispute resolution) that the bank must ensure are considered, included in the affiliate agreement, and reviewed by bank counsel. It is common practice for the bank's legal team or outside counsel to provide comfort to the board and management that the non-price terms are consistent with market terms for the type of transaction in question. In many cases, consistent with a cautious approach to affiliate transactions, non-price terms and conditions agreed to between a bank and an affiliate err on the side of being more favorable to the bank than the bank might obtain in a similar transaction with an unaffiliated party.

It may also be helpful to articulate enterprise standards and LOB and controls function procedures for applying the market terms requirement, and then tailoring the procedures appropriately in light of the unique attributes of different types of products. It may also be useful to outline routines that should be followed prior to execution and to assess whether the transaction is on market terms.

Post-execution follow-up can be helpful in complying with this requirement on an ongoing basis. Given the complexity of doing all this, a matrix that details the following can help develop enterprise standards:

- Type of affiliate transaction or product.
- Guidance or standards for assessing market terms for transaction type or product.
- Methods for substantiation and timing.
- Location of supporting documentation.
- Responsibility for conducting the analysis and ensuring market-based terms.

This continues to be an area that banks are challenged with given either lack of sufficient detective controls or controls and reporting that are executed at a delayed timing and not necessarily at the time of trade or end of day. Banks are continuing to review their controls to determine how to further automate the market terms checks and reporting and also leverage other controls within the organization such as best execution and transfer pricing controls.

Intercompany agreements

Regulation W devotes substantial attention to the payment of money or the furnishing of a service to an affiliate under contract, lease, or otherwise. Intercompany agreements typically document such services, setting forth the type of and terms by which one legal entity will provide services to another in exchange for fees. The regulation requires that intercompany agreements comply with the market terms requirements of Section 23B. That is, fees paid to affiliates for services need to be on comparable terms with those that would be paid to non-affiliates for similar services.

Separately, there may be revenue-sharing agreements that apply revenue between businesses that book in the bank versus the affiliates.

Banks typically have numerous legal entities with many contractual relationships between them—and tracking these relationships can present some challenges. A centralized repository containing existing and new intercompany agreements, as well as centralized monitoring and maintenance of intercompany agreements with affiliates, is increasingly essential, particularly for large and complex organizations, to comply with Section 23B requirements. An ongoing assessment of whether services to affiliates are comparable with market-based transactions requires accurately capturing the services provided, terms, and conditions.

Additionally, it is important to enforce consistent financial accounting for services provided with respect to booking receivables and payables between different legal entities, based upon the 23B requirements of Regulation W. Standardized booking practices, use of existing financial systems to track legal entity financials, and cash settlement mechanisms should be required for intercompany agreements between legal entities.

Centralized monitoring

Due to the technical difficulties with Regulation W, a bank's ability to develop an effective compliance program will likely hinge on centralized automated monitoring. Quarterly FR Y-8 report filings may be supplemented with more frequent internal daily and weekly reporting that provides the required and more centralized monitoring across all LOBs. It is important that reconciliation of Section 23A and 23B transactions between LOB reporting and the bank's books and records from a centralized view occur frequently. This can help to verify that controls across respective units (controllers, finance, regulatory reporting, legal entity reporting, business units, etc.) are capturing aggregate transactions subject to collateral and/or that they are captured and applied against the quantitative limits applicable under Section 23A.

Taking a closer view, regular monitoring is required and differs by product. For traded products in which value is more subject to market movements, the monitoring of positions, collateral, and limits becomes more pressing. This contrasts with a loan in which values usually remain constant and are typically subject to change with its agreed-upon amortization schedule or periodic off-cycle paydowns. In this case, the monitoring of collateral should be more relative to the remaining balance of the loan and assessing if the amount of posted collateral still covers the remaining loan amount. To the extent that the type of collateral posted isn't volatile, there may be opportunities to release collateral as the loan balance decreases.

Getting to the next level

Banks should consider the necessary investments and changes to their structures and processes to comply with the now more than 20-year-old formalization of the Section 23A and 23B requirements of the Federal Reserve Act, as implemented through Regulation W—especially because federal regulators are continuing their focus on compliance as business models and approaches to intercompany transactions have evolved. It means building a consistent view of their infrastructures and control framework, while developing relevant policies, procedures, and reporting mechanisms that oversee affiliate transactions, within each legal entity at the organization. While there are plenty of challenges and complexities involved with Regulation W, banks could stand to benefit by potentially reducing the risks associated with regulatory reporting and compliance for Regulation W and improving their legal entity governance and reporting.

As banks begin developing their compliance governance, processes, and technology capabilities to meet current compliance requirements, they should consider taking a pragmatic view of Regulation W compliance. This means they should balance what is practical from a cost perspective with what is ideal in the new regulatory landscape. In the long run, this should help them achieve a sustainable and robust Regulation W compliance program.

Endnotes

1 Federal Reserve Act, Pub. L. No. 63-43, 63rd Cong. §23A (1913). See also Banking Act of 1933, Pub. L. No. 73-66, 73rd Cong. (1933) (Glass-Steagall Act). 12 USC§ 371c.

2 Federal Reserve Act, Pub. L. No. 63-43, 63rd Cong. §23B (1913). See also Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 100th Cong. (1987). 12 USC§ 371c-1.

3 12 CFR Part 223 (Regulation W). Federal Reserve Board of Governors (FRB), "Frequently Asked Questions about Regulation W," last updated December 2021. See also FRB, "Availability of Information, Public Observation of Meetings, Procedure, Practice for Hearings, and Post-Employment Restrictions for Senior Examiners; Savings and Loan Holding Companies," *Federal Register*, September 13, 2011.

4 Transactions between a US branch or agency of a foreign bank organization and certain affiliates are subject to Sections 23A and 23B and Regulation W. In general, however, the universe of companies that are considered to be "affiliates" of a US branch or agency is narrower in comparison to insured depository institutions (IDIs), consisting of companies that engage in activities that are "financial in nature" as authorized by section 4(k) of the Bank Holding Company Act, including companies engaged in insurance underwriting, securities underwriting and dealing merchant banking, and insurance company investment activities in the United States. 12 USC§ 1843(k)(4); 12 CFR 223.61.

5 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 111th Cong. (2010) (Dodd-Frank Act); FRB, "Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations," *Federal Register*, November 1, 2019.

6 See e.g., Federal Reserve Board of Governors (FRB), "Bank Holding Company, Supervision Manual," Section 2020, last updated February 2023.

7 Banking Act of 1933, Pub. L. No. 73-66, 73rd Cong. (1933) (Glass-Steagall Act); An Act to amend the Bank Holding Company Act of 1956, Pub. L. No. 89-485, 89th Cong. (1966); Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 100th Cong. (1987); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 106th Cong. (1999). See also 12 CFR Part 223 (Regulation W); FRB, "SR 12-17 / CA 12-14: Consolidated Supervision Framework for Large Financial Institutions," December 17, 2012.

8 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 111th Cong. (2010) (Dodd-Frank Act); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 106th Cong. (1999); Sarbanes-Oxley Act of 2002, Pub. L. No. 107-610, 107th Cong. (2002). See also 12 CFR Part 225 (Regulation Y); 12 CFR Part 243 (Regulation QQ); 12 CFR Part 381.

9 12 USC §1851.

10 For additional information on the options available, see Deloitte, "Reimagining the role of the front office in complying with banking regulations," 2018.

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