Enhanced Prudential Standards for Foreign Banks

One year in, and miles to go

Produced by the Center for Regulatory Strategies

February 2015 marks a year since the Federal Reserve released the final rule on Enhanced Prudential Standards (EPS) for large Foreign Banking Organizations (FBOs). So why doesn't it feel like old news?

In practice, EPS implementation is really just getting started, even with the completion of the Implementation Plan filing January 1, 2015. Leaders in some institutions may be finding that they have underestimated the scale of the transformation it will require, the scope of the decisions that they may have to make, and the amount of time that they have to get it done, particularly with July 1, 2016 looming closer.

For some FBOs, the last 12 months have been more advanced than for others. Federal Reserve officials have provided guidance through multiple forums and delivered speeches, and on-site teams have followed-up with their institutions. Importantly, FBOs have gained a reservoir of first-hand knowledge from their compliance efforts so far; however, more intensive work is still to come and stands to reflect a significant transformation across the organization in the US and at the respective parent bank and other operations. Looking forward, large FBOs will need to double-down on their EPS efforts – or, if necessary, accelerate efforts to meet the effective dates.

Here are a few of those potential "lessons learned" by the FBOs, as the EPS completes its first lap around the calendar.

The standards have brought a new focus to size and structure. Because the $50 billion in US non-branch assets threshold triggers the most intensive requirements, a number of FBOs have proactively reviewed business strategies in the US and some are restructuring their US operations. Meanwhile, FBOs with existing bank holding companies (BHCs) have some deadline advantages over ones that do not, and large FBOs with BHCs may revisit their entity structures if their capital market entities currently lie outside the BHCs. The competitive landscape, as a result, has become further nuanced.

For large FBOs, the new EPS rules are part of a larger array of pressure points that may also include parent company initiatives, home country regulations, cost reductions, rationalization of US operations, and integration with regulatory regimes from multiple jurisdictions. FBOs that need to create intermediate holding companies (IHCs) under the new US rule are working hard to build the required boards, since director selection is a central and important process that takes time.

The Implementation Plans were not only a compliance requirement, but served as a key quality assurance and governance mechanism to rally organizations around planning, designing and gearing up for execution. They facilitated the need for diligent and detailed review and approvals from US to senior level approvals within the parent banks and their boards. The review cycles to create a credible plan also highlighted additional areas of integrations or gaps in programs that would need to be addressed in 2015 as programs turned toward execution.

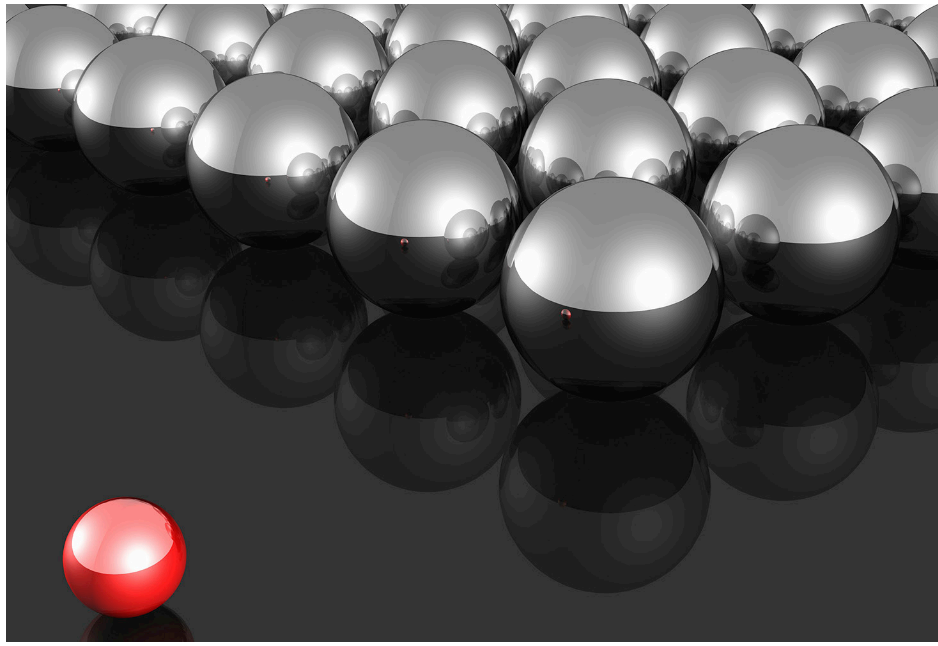
The Implementation Plans are also attracting extra scrutiny from their parent banks and from both home country regulators and US regulators. In positioning themselves to meet that scrutiny and operate under the prudential standards, FBOs are finding it necessary to increase their subject-matter expertise in areas such as risk management, capital, governance, and compliance, particularly expertise regarding application of these US rules.

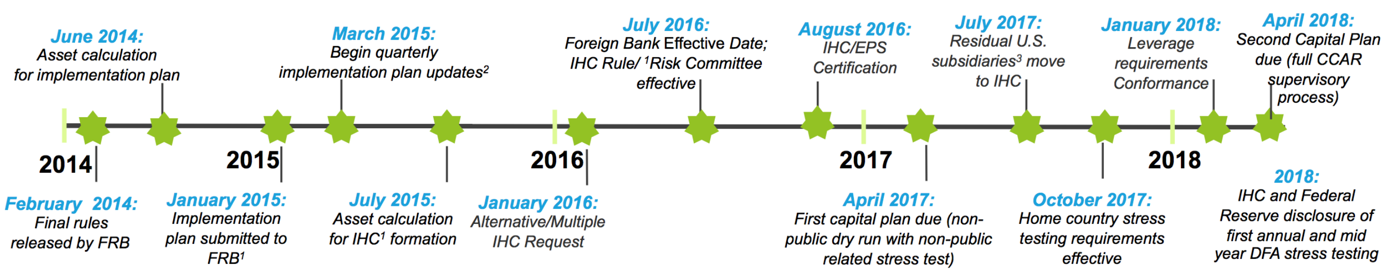
These developments mean significant transformation for many institutions. In many cases, the transformation is likely to challenge the parent's global operating model and desire to implement globally aligned cost efficient solutions.

What's happening now?

The Federal Reserve will utilize the Implementation Plan to assess and monitor the FBO's progress in executing its plans for building capabilities to comply with EPS. Illustrated below are upcoming milestones that FBOs will need to contend with to prepare for going live. These are the key dates highlighted in the final rules.

The first half of 2015 is an important period for the FBOs. While the FBOs are spending time and energy on executing their plans, it is fully expected that the Federal Reserve will start to engage with institutions in formal sessions and as part of horizontal reviews on key aspects — IHC structure, capital, liquidity, and risk management. Formal feedback on plans is expected in the second quarter or so. Therefore, FBOs should be proactive in conducting introspective self-assessments of their programs, and prepare reporting and progress packages to faciliate reviews of the Plan both for internal governance forums and for external stakeholders.





[1] Applicable to foreign banking organizations that have US non-branch assets of $50 billion or more as of 6/30/14. Ninety percent of non branch assets transferred to IHC. US non-branch assets are defined as equal to the sum of the consolidated assets of each top-tier US subsidiary of the Foreign Banking Organization (excluding any section 2(h)(2) company and DPC branch subsidiary, if applicable).

[2] Quarterly implementation plan updates expected beginning January 2015 through January 2018 for IHC formation and risk and liquidity compliance implementation.

[3] 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 US 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.

What are important considerations at this stage?

Deloitte has identified a discrete set of considerations that apply to many FBOs as they work to implement the new EPS rules.

Significant business impacts with dynamic capabilities is expected

- Focus on business impacts, with more significant changes likely to come. It will take dynamic modeling and constant front office engagement to maintain alignment to global planning processes, booking model changes, implementation plan monitoring, and business strategy.
- Endeavor to provide transparency of the booking model. Regulators will expect that revenue and asset flows are well understood and explainable.
- Expectations for CCAR continue to rise requiring significant senior management attention. Communication, strong project management practices, and alignment with global stakeholders in understanding the scope, scale and complexity of changes are critical. The business impacts should not be underestimated.

Cultural alignment and implementation of US-centric governance model is a key

- Consider cultural alignment changes and set awareness considering global linkages. It may be a significant challenge to secure strong support from the parent bank board, senior management, and US management for change on this scale. Invest the time with global stakeholders to determine an appropriate level of understanding is in place to engage with US requirements.
- Implement a US-centric governance model. A committee structure for US operations needs to be established to address regulatory expectations, reflect the business profile, and a balance between US-centric and global decision-making.
- Implement an effective three-lines-of-defense risk management framework. Draw on lessons from US governance examinations, parent bank initiatives based upon Basel, and home country regulatory momentum.
- Assess EPS impact on US branches. Functions that have branch requirements — risk, liquidity, and governance — should outline clear ownership and accountability according to rule requirements.

Building data and IT capabilities to support the IHC and US operations is challenging

- Develop regional IT infrastructure. Create clear dependency maps between global programs and regional implementations.
- Build data quality and governance. FBOs will need sustainable commitment and resourcing to build comprehensive data governance frameworks that define accountabilities for data quality and put effective controls in place.

Critical implementation considerations in preparation for go-live

- Facilitate cross-functional coordination on developing reporting capabilities. Reporting and deliveries should account for financial, risk, senior management MIS, IHC board, and governance forum reporting, as well as support of key US roles.
- Develop, enhance, and validate risk model for US operations in a timely manner. The sequencing of work, the volume of models, and the timing of Federal Reserve review could pose challenges.
- Evaluate home-country stress testing capabilities. Some FBOs may need to measure their current practices against Federal Reserve expectations and build new processes to satisfy EPS certification requirements.
- Reevaluate US operations service models and vendor management processes in light of new business model and resolution planning. Define changes to vendor management processes for US operations that may be needed to address FBOs' new business needs.
- Prepare for go-live by developing operational readiness plan. Establishing new business processes and augmenting existing ones by July 2016 will require a significant level of coordination, implementation precision, testing, and validation.

Robust program management is critical

- Implement strategic solutions, robust decision making and project management processes. The lessons FBOs have learned from legal entity and framework projects, recovery, and resolution planning work can help avoid duplication. Prioritize EPS efforts and initiatives — efforts that require long lead time will affect run-the-bank operating models and require parent bank support.
- Continue to monitor the regulatory landscape for heightened regulatory expectations and implement a robust "trust and verify" program management. As regulators sharpen their focus, banks should be ready with a strong foundation, including IT infrastructure, data governance, and allot additional resources to remain ahead of likely change. Bringing an M&A-like focus to regulatory developments, evolving regulatory expectations and coordination will help banks move toward readiness.
- Coordinate and align US regulatory programs and deliverables. Governance forums and other means can help FBOs align on regional program differences and communication to regulators. Coordinate with other regulatory and business initiatives with focus on ones that could impact the EPS program in both a US and global context.
- Focus on filling open resources aggressively and forecast demand. Tracking retention of key subject-matter resources and quick mobilization of available personnel will reduce cost for the program and may prove to be a competitive advantage.
- Establish effective internal and external communication channels and protocols. Develop clear roles and responsibilities for internal and external stakeholder management, and use industry forums and the Federal Reserve mailbox for clarification.

What are the critical next steps?

Deloitte has identified some potential considerations for next steps that can help frame some of the activities that are taking place in Q1/Q2 of 2015.

- Develop and track an implementation plan follow-up list – the "worry list" and "back pocket list" of follow-ups, questions, issues, and additional decisions that were outstanding at the time of filing.
- Monitor key decisions in detail to facilitate an audit trail.
- Facilitate senior management and board oversight to clear implementation bottlenecks with a critical path view that at this point should not change.
- Review program scope and structure and launch additional workstreams that represent horizontal or integrated views.
- Follow up on parent bank dependencies and certifications to make sure of lead times on required sign-offs.
- Determine front to back target operating model is clearly defined across functions and workstreams.
- Align to parent bank reforms and initiatives, and track global operating model changes that could affect US operations.
- Calibrate funding requests and subject-matter expert (SME) assignments based upon the critical path and milestones that are necessary for the EPS program.
- Build a program communications workstream that focuses on internal and external stakeholders to assist in the recognition of the level of change and transformation the organization could experience.
- Focus on execution and evaluation of organization-level readiness for the effective date and beyond.
- Build quality assurance at all levels within the program.
- Make compliance and internal audit roles more prominent in keeping with their second-line-of-defense and third-line-of-defense roles.
- Trace requirements, capabilities, milestones, and deliverables from the program.

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