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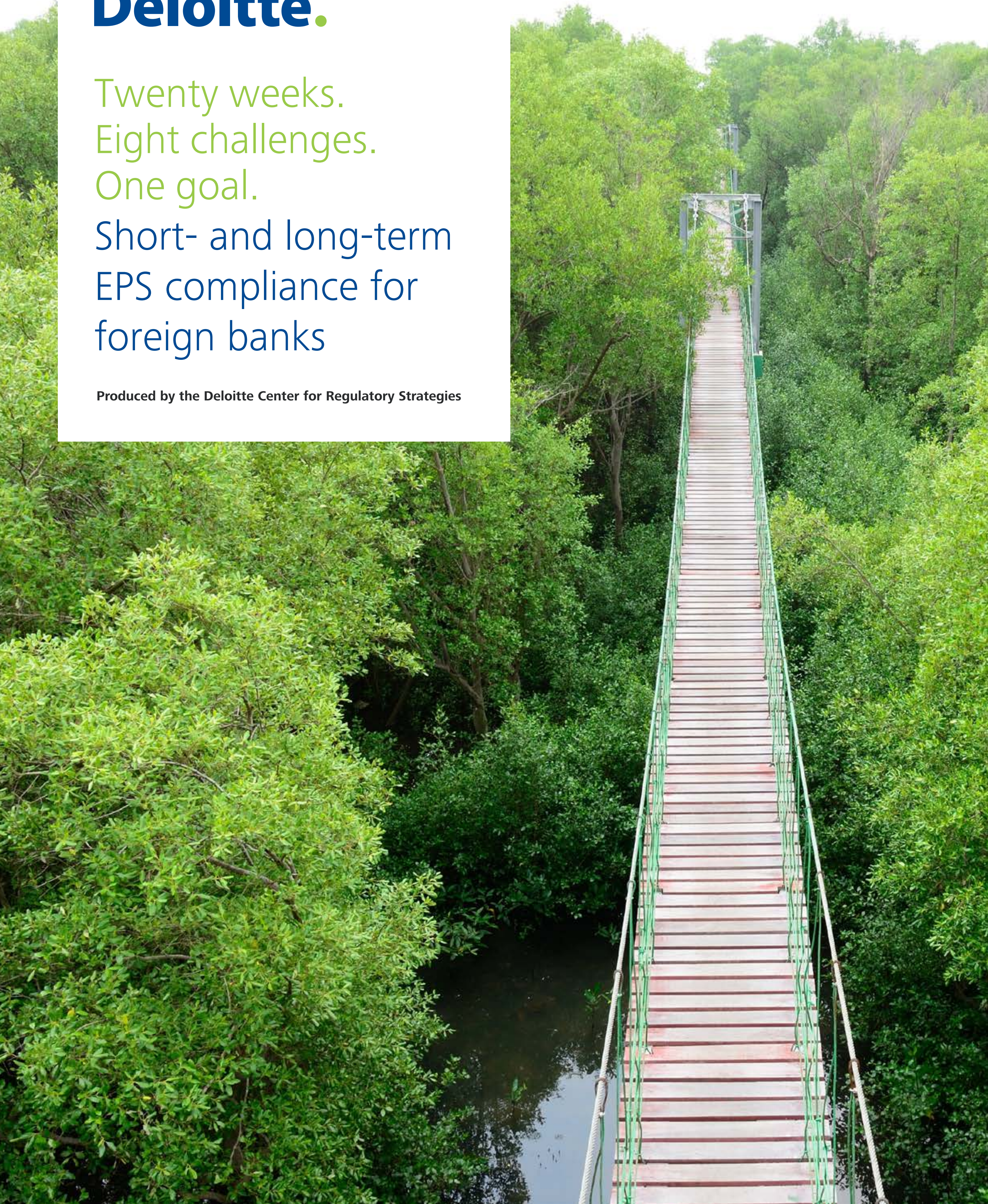
Twenty weeks. Eight challenges. One goal.

Short- and long-term EPS compliance for foreign banks

Produced by the Deloitte Center for Regulatory Strategies



The July 1, 2016 effective date for the Federal Reserve Board's final rule on Enhanced Prudential Standards (EPS) for Foreign Banking Organizations (FBOs) is coming up fast. Nearly two years after the rule was finalized, affected banks need to focus on this go-live date. But they also need to look beyond it—and realize that the EPS go-live date is only the beginning of a new approach to governance, risk management, capital, and liquidity. We expect regulators to have high expectations for July 1, 2016, as they would argue that FBOs have already had more than three years to put this in motion since the first notice of proposed rulemaking. The regulators are ramping up their supervision and have changed their approach to align FBOs to the same portfolio as US Bank Holding Companies (BHC), and FBOs should expect the same level of attention.

As part of our ongoing series on FBO-EPS, the eight challenges identified here can help banks meet the future head-on.

FBOs with more than $50 billion in US non-branch assets are subject to the most expansive requirements[1] under the new rule. Most notably, they must create US intermediate holding companies (IHCs) and will be subject to heightened expectations for governance, risk management, capital planning, and stress testing. Already, many of these large FBOs have devoted significant resources and efforts to that mandate—they've reviewed their business strategies, implemented infrastructure and organizational changes, and restructured certain operations. Affected FBOs must finalize their IHC structure and capitalization by the July 1 date, and they must certify their compliance with EPS by August 1, 2016.

However, the job doesn't end there. Many other key processes, deliverables, Federal Reserve reviews and final requirements will unfold over the course of the first 24 months:

- Each FBO is required to begin functioning as a regional holding company with an IHC board of directors, CEO and CRO that are holding regular meetings on business strategy, risk, compliance, and the status of EPS initiatives and implementation. Moreover, they are required to take a holistic view of their US operations (i.e., the IHC and branch and agency operations) through a US risk committee and US CRO.
- FBOs are required to implement risk management frameworks and related policies and procedures specific to the IHC and US operations.
- IHCs are required to submit select initial financial regulatory reporting as of Q3 2016 data.
- They become subject to the Federal Reserve's capital planning rule and related guidance—with the first plans due in April 2017, and become fully subject to the stress testing rules in 2018.
- The Federal Reserve will initiate a "dry run" or more limited version of its Comprehensive Capital Analysis and Review (CCAR) of IHC capital plans and provide feedback in mid-2017. Starting in 2018, IHCs will be subject to the full CCAR process.
- Several unsettled issues leave significant "uncharted territory" where the Federal Reserve must still define its policy position, including Single Counterparty Credit Limits (SCCL), Early Remediation Requirements, finalization of the Liquidity Coverage Ratio (LCR) for FBOs, Net Stable Funding Ratio (NSFR), and Total Loss Absorbing Capital (TLAC).
- The Federal Reserve is also planning more updates in 2016 to its regulatory reporting forms, particularly for liquidity reporting and is planning on issuing further guidance on governance which will need to be considered.

Clearly, adherence to the new EPS regime will remain an active challenge long after the mid-year effective date. Rather than simply setting forth a timeline for IHCs to follow, this framework establishes a comprehensive change-the-bank project. It changes the nature of the job—from racing to meet a deadline to creating and sustaining a new way of running the organization and doing business in the long term. Infrastructure and robust project management capabilities should be in place to address feedback and develop consistent and achievable plans across all levels of the organization to meet the evolving and rising supervisory expectations.

Eight EPS challenges for FBOs

1. Demonstrate readiness to go live on July 1
2. Build sustainable compliance
3. Demonstrate US governance using clearly defined roles within the "three lines of defense"
4. Align with the group or parent
5. Plan for life beyond July 2016
6. Manage the talent dimension
7. Don't take on EPS in a vacuum
8. Get a step ahead of data and automation challenges

1 EPS requirements and an overview of their impact — http://www2.deloitte.com/us/en/pages/regulatory/enhanced-prudential-standards-financial-services.html

As additional requirements become applicable to IHCs, it remains unclear how the supervisory examination program for these institutions will evolve. How will the Federal Reserve's supervisory rating system apply to FBOs in general? How will it bear on IHCs specifically? Whatever the details, it seems safe to expect that regulators will continue to have heightened expectations, and they are likely to apply BHC expectations to the IHCs.

Stabilization of the new requirements is still years away, and the first year of life under the new rule will likely be a "shakeout" period that unmasks a regular stream of new supervisory issues. As always, those will take the form of supervisory comments—in the form of *Matters Requiring Attention* and *Matters Requiring Immediate Attention* that require banks to take remediation action. Meanwhile, other areas that require remediation and greater focus will emerge through the examination process. The domestic banking firms provide a good example of the implementation learning curve, and the time it takes to achieve sustainability.

Regulators have made clear that they will measure each IHC's progress relative to their expectations as of the go-live date of July 1, 2016. But they have also acknowledged that standing up a new IHC so it can operate with clear governance—with a senior management that operates within that structure and applies risk management, controls, and oversight through a legal entity lens—is a difficult job. In areas such as liquidity risk management, where existing supervisory feedback has been noted and pre-dates the new EPS rule, regulators will expect the IHCs to develop integrated solutions to regulatory requirements and refine new practices on a continuous and iterative basis.

Going forward beyond the implementation date of July 1, "sustainability" will be the watchword critical to each IHC's success: sustainable compliance and sustainable responsiveness to regulatory change functions. Demonstrating effective governance and local risk management capabilities will become key. Whatever the requirements are on paper, the most enduring measure of effective compliance will be whether an IHC and its combined US operations are viewed by regulators and the market as "resilient" and able to withstand various company-specific and industry shocks. It is time for a reality check on where you are in your FBO implementation process. Everyone from first-line risk managers to board members should understand and agree upon what will be in place by July 1, 2016, and what will need additional plans to address down the road.

What should FBOs be doing at this stage?

The impact of these regulations and the starting point in legal entity structure and the business strategy and product mix drive the complexity of implementation. No two situations are alike. Nevertheless, Deloitte has identified eight critical challenges that apply to many FBOs as they work to implement the new EPS rules.

Challenge 1: Demonstrate readiness to go live on July 1

Dry-run and test readiness through front-to-back simulations.

Can new processes such as risk appetite and business planning, and new governance structures such as delegation of authority, escalations, or execution of a mandate, make the move from on-paper designs to real life operations through rigorous simulations? These readiness tests need to involve key stakeholders including the IHC board, US risk and other committees, business lines, and support functions. They need to encompass processes that cut across all organizational lines: group-parent, parent-US, functions, and governance forums. In some cases, the FBO program team may already be performing limited dry runs, but those are not a substitute for a full-scale test. Make sure the scope, coverage, and ambition of this exercise is transparent and well-documented.

Mobilize key senior management leaders (CRO, CFO, etc.) and board members. Onboard them into their new roles—and have them begin playing those roles now.

Don't underestimate how long it takes to train and onboard even an experienced leader into a new situation. Make sure you are dedicating enough time to this process, which will need to balance current business needs and future expanded roles. When a new legal entity faces a new regime of day-to-day oversight, operations don't click without preparation. Put new joiners, or those that have changed or expanded roles, to the "use test" with situational training and on-boarding plans that ensure they'll have the tools to be effective on Day One. The dimensions of this preparation can include job profiles, decision rights, limits, delegations, and reporting/MIS.

Communicate, communicate, communicate.

All employees at the group, parent, and US levels need to understand what it will mean to operate and manage operations within the currently unfamiliar new requirements. For most FBOs, the IHC is a new perspective, and some functions will require extensive targeted training and socialization. Making people ready for that degree of change will require a formal communication plan, which can include elements like town halls, video messaging and regular updates. The pace and intensity of change will increase to and through July 1. The energy behind the communications plan should do more than just keep pace. It should be a step ahead.

Challenge 2: Build sustainable compliance

Have a transition plan that will take you from "change the bank" to "run the bank."

How can management communicate that it is ready to meet the requirements and certify its compliance with the rules? What roles should business functions, compliance and internal audit play in making the transition to business as (new) usual? As a starting point, consider defining the way each project deliverable traces from underlying requirements—and document each box as it's checked. Prepare compliance, and other run-the-bank functions like operational risk and audit, to take on their ongoing roles in complying with Regulation YY. Avoid ambiguity here, and be very clear on what each line of defense capabilities are and what is being signed off. Demonstrate the underlying support that has gone into delivering on Regulation YY requirements, by tracing each step from a specific underlying requirement, and conducting a sign-off and certification process; this needs to be customized and completed across all three lines of defense.

Ensure regulatory change capabilities are in place for sustainable compliance for and beyond EPS.

New rulemakings related to EPS, such as SCCL, are still on the horizon. As regulations continue to evolve and oversight becomes more robust, it is critical *now* to make sure clear regulatory change management responsibilities and capabilities are in place. The ability to analyze proposed changes, internalize final changes, and then operationalize these changes in daily operations is the key to remaining efficient and competitive. Tomorrow will be too late to revisit the roles, responsibilities, and operating model that determines how new regulatory changes are communicated, implemented, and aligned to run-the-bank functions.

Challenge 3: Demonstrate US governance using clearly defined roles within the "three lines of defense"

Develop and document a cohesive operating model for three lines of defense.

Roles and responsibilities must be clearly outlined across business lines, control functions, and audit. In most cases, the first line of defense is the front office, and it is critical for FBOs to be able to demonstrate that the first line is using legal entity processes to risk manage and run the business. FBOs can do this by pointing to controls, processes and actual "use tests." Control functions operate as the second line of defense for the Regulation YY framework, monitoring, and testing, and Internal Audit is the third line of defense for assurance and testing across the first and second lines of defense. This structure becomes even more important in certain areas of the new EPS rule, such as independent review requirements, where the Federal Reserve has been explicit about the specific requirements that each of the three lines of defense must address.

Demonstrate ability to operate autonomously in the US, within clear delegation of authority from the group or parent.

Additional supervisory guidance is expected on this issue next year—but it is clear that demonstrating local accountability and decision-making authority will be one of the key tests of whether an FBO has implemented the "spirit" of Regulation YY. Other global regulatory requirements that might conflict with the US EPS requirements, and overall communication from the parent and the US organization become critical in managing dependencies and ensuring smooth and consistent implementations.

Challenge 4: Align with stakeholders across parent and other jurisdictions

Take the time to make sure global stakeholders understand the new US requirements.

As we get closer to Day One, the analyst questions will only increase. Many of the reporting forms will publicly disclose the financials of the IHC, and the finance organization will need to be prepared for that. People immersed in the US rule implementation and people for whom it is a distant abstraction will have to align on the way governance is actually going to work in practice—and the way the IHC board interacts with the group board will need to be thought through. This need for alignment will also be important in conducting bottom-up US planning: How will this work with the group practice? Specific parts of the requirement, such as home country stress testing, will require sign-off and certification of group capabilities.

Take a fresh look at the group processes that must align to US regulations and supervisory expectations.

Many FBOs have historically relied on their group processes for capabilities that now must support US capital, liquidity, and risk management requirements under the new EPS rule. MIS/Data are global systems that now must support multiple views at the US legal entity level—views that cut across currency, presentation, underlying scope, and basis. As both formal and informal regulatory requests call for ever-increasing levels of detail, and as some requests drive the public release of previously confidential data, scalability of systems will be key.

Challenge 5: Plan for life beyond July 2016

Understand where you may fall short—and have a credible plan in place.

Among the capabilities an FBO has built to support EPS Day One, which are tactical rather than strategic solutions? Learn from the past—this will probably not be the first time the race to implement short-term fixes for compliance requirements fell short of long-term sustainability. Use the supervisory feedback that arrives through other existing channels to highlight these potential shortfalls, document them, and plan how to close them (or work credibly toward doing so) even before Day One. Be proactive and obtain feedback where you are not clear on capabilities. A clear expectation of automation and infrastructure will likely be one area where many will have ongoing work to do, but it's still important to spend the time it takes to have a clear vision of how that will be achieved.

Continue to monitor the regulatory landscape for heightened regulatory expectations and implement robust "trust and verify" program management.

As regulators sharpen their focus, banks should be ready with a strong foundation—including IT infrastructure and data governance—and allot additional resources so they can keep a step ahead of required change and integrate their regulatory change programs. Prioritization will become important to effectively deploy the finite change capacity that a bank has.

Deliver on CCAR requirements

A significant portion of EPS connects and provides a foundation to deliver on CCAR. For instance, risk identification processes—which are needed to support the risk appetite and risk management framework for EPS—are the foundation for stress testing in CCAR. FBOs will need to ensure that the connectivity of what EPS delivers for CCAR is made clear, and ultimately build confidence and demonstrate readiness for CCAR capabilities through 2016 (to prepare for the first capital plan submission in April 2017).

Challenge 6: Manage the talent dimension

Consider aggressive talent retention strategies.

Understand which key stakeholders will need to perform the run-the-bank activities necessary to demonstrate compliance, and protect them. Lay out a clear vision so everyone understands how risk management and compliance professionals will be critical to the future effectiveness of the bank, and implement compensation and incentive programs that recognize and align with the risk management and governance disciplines that are so important under EPS. Evaluate the needs for technically skilled people (capital, liquidity, stress testing, and risk) who have vision, are strong change agents, and will align the US-oriented views that will be needed to develop a sustainable IHC operation.

Challenge 7: Don't take on EPS in a vacuum—build into sustainable compliance

Coordinate with other regulatory programs

EPS requirements are broad in scope. But they intersect with other in-process or soon-to-arrive regulatory changes that don't fall within that broad scope, such as the Volcker Rule, Recovery and Resolution Planning, SCCL, the LCR, and the NSFR. Making the new EPS rule, the other new rules, and the regulatory remediation already in effect all work together is up to the FBOs. Taking this broad view can help stem duplication of effort, avoid conflict, and improve the efficiency of senior managers, subject matter experts, and funding. The regulatory requirements may appear discrete on paper, but the FBO has to live them all simultaneously.

Challenge 8: Get a step ahead of data and automation challenges

Develop a sustainable data governance model that demonstrates and enables complete, accurate and timely reporting

The data requirements that are needed to support risk, finance, and business regulatory and MIS reporting across the FBO demand significant data consistency, granularity, and aggregation capabilities. Many FBOs will not be completely able to support complete, accurate, and timely reporting across these dimensions by Day 1. Having a clear data governance model in place that will demonstrate success and sustainability over the course of 2016 and beyond will become a key focus.

Invest in a strategic risk and finance technology vision that is one step ahead of today's data problems

It's key to have a clear technology roadmap and vision of what the FBO's management team believes is the right level of detail, frequency, and content for reporting and data capabilities to manage its US operations. Ensuring that the data is consistent, automated and aligned with future needs will become critical to demonstrating a credible future plan to address likely shortfalls.

What are the critical next steps?

It's not possible to envision and list every step that must go into EPS compliance. But with only 20 weeks before July 1, 2016, the reality is that most FBOs will have to set priorities. Above all else, FBOs should identify and understand the areas where they are likely to fall short—and invest in the steps that can deliver meaningful progress prior to Day One. Achieving readiness is critical, but so is effectively demonstrating it, and that puts a premium on use cases, dry runs, and full-scale simulations. And whether someone is new to the organization or just facing a new role, everyone with a role to play will require time to train.

The two years since the FBO EPS rule first appeared in draft form have sped by. The handful of days that remain before the go-live date will go by even faster. By taking on the eight discrete challenges outlined here, FBOs can keep up their speed, accelerate to and through the target, and build sustainable compliance that can not only satisfy regulators, but also improve performance.

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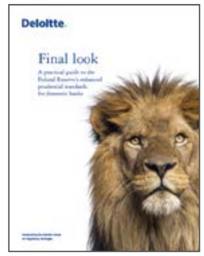

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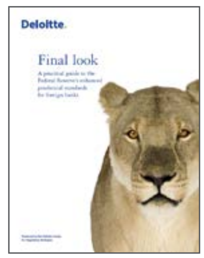

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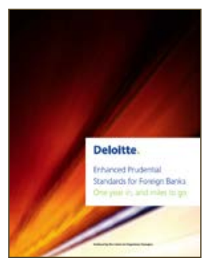

Enhanced Prudential Standards for Foreign Banks—One year in, and miles to go

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