

Financial Services

Global Regulatory Network executive briefing

Enhanced Prudential Standards for Foreign Banking Organizations

Overview and timing

On 18 February 2014, the Federal Reserve Board approved the final rule (the Rule) establishing Enhanced Prudential Standards (EPS) for large Foreign Banking Organizations (FBOs) and US Bank Holding Companies (BHCs). This briefing focuses on the application of the Rule to FBOs.¹

As expected, the Federal Reserve has implemented the Intermediate Holding Company (IHC) requirements largely as proposed: the largest FBOs operating in the US will be required to consolidate all US legal entity ownership interests under a single, top-tier IHC. The IHC will then be subject to Enhanced Prudential Standards similar to those of BHCs, including capital, liquidity and risk management requirements.

Key changes in the Rule include a deferred compliance date, reduction in scope of the FBOs that will need to establish an IHC, introduction of a new Implementation Plan requirement and exemption of the IHC from the "advanced" Basel III measurement requirements. Given that the proposed applicability of the Collins floor to the IHC would have prevented any benefit from adopting advanced approaches, this exemption relieves one aspect of a substantial compliance burden. However, US Basel III market risk and standardized credit risk calculations are still required and, given the differences from CRD IV standards, remain a significant implementation effort. Several key decisions were not finalized in the Rule (e.g., the Liquidity Coverage Ratio, Single Counterparty Credit Limits and Early Remediation Requirements), but these are expected to be applied to the IHC once they are finalized for BHCs.

The Rule establishes a timeline for FBOs to form an IHC and consolidate US legal entities under it, extending the proposed IHC formation date by one year, from 1 July 2015 to 1 July 2016. However, with this extension comes a significant new requirement: FBOs are required to submit a detailed Implementation Plan to the Federal Reserve by 1 January 2015. The Implementation Plan should include pro-forma IHC financials and regulatory capital ratios, planned actions to structure and capitalize the IHC, and details describing how the IHC will comply with the risk management and liquidity requirements of the Rule. There are some important timing clarifications for the Comprehensive Capital Analysis and Review (CCAR), stress testing (including the related public disclosure requirements, see below) and leverage ratio requirements.

¹ Based on the draft Federal Register version of the final rule; final Federal Reserve version had not been issued as of 25 February 2014.



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Key dates

1 January 2015	Implementation plan due
1 July 2015	IHC designation effective date
1 July 2016	US IHC formation (consolidating all US BHCs, US Insured Depository Institutions (IDIs) subsidiaries and 90% of non-BHC US assets)
5 January 2017	First capital plan due (not subject to public disclosure)
1 July 2017	Completion of all remaining asset transfers into IHC
5 January 2018	Capital Plan and Dodd-Frank Act Stress Testing (DFAST)/CCAR stress tests (subject to public disclosure)

Scope of IHC formation

The IHC is now required only for the largest FBOs with US non-branch/agency assets of US\$50b or more, rather than the lower US\$10b threshold in the proposal. FBOs with smaller US footprints were granted some reprieve: FBOs with less than US\$50b of US non-branch assets are no longer required to form an IHC. However, FBOs with US\$10b or more in non-branch/agency assets will be subject to the enhanced capital and liquidity stress testing requirements, along with certain risk committee requirements (if the FBO is publicly traded), an annual liquidity risk stress test, and certifications regarding home country risk-based capital compliance and stress testing. While branch and agency assets are not required to be included in the IHC, those firms with more than US\$50b of combined US assets face higher risk governance and liquidity standards that apply to both the IHC and combined US operations (IHC plus branches and agencies). These asset thresholds and regulatory reporting for the IHC are to be measured on a US GAAP basis.

The Rule requires the entirety of the FBO's ownership of all US legal entities to be transferred to the IHC with limited exceptions (i.e., section 2(h)(2) companies and Debt Previously Contracted (DPC) branch subsidiaries). The Rule clarifies that an FBO may not retain any interest in a US legal entity directly or through a non-US affiliate. However, the Rule does not require an FBO to own 100% of all US legal entities. Some limited flexibility has been granted in the timing for the consolidation of entities under the newly created IHC; the Rule requires all subsidiary US BHC and IDIs, in addition to 90% of non-BHC US assets, to be consolidated under the IHC by the initial formation date of 1 July 2016. The remaining legal entities must be consolidated by 1 July 2017. The Rule also notes that if the existing BHC subsidiary transfers assets to the IHC prior to 2018 (in an attempt to minimize capital requirements on the BHC), the Federal Reserve may accelerate the application of the capital and stress testing requirements to the IHC prior to 2018.

The Rule clarifies that an existing entity (e.g., an existing BHC) can be designated as the IHC and leaves open the choice of corporate form for the entity. The Federal Reserve retains the ability to approve a dual IHC or other alternative structure and to exempt the ownership interest in certain subsidiaries, but these are expected only in limited circumstances.

The new Implementation Plan requirement

FBOs are required to submit an Implementation Plan for the IHC to the Federal Reserve by 1 January 2015. The Implementation Plan should include, but is not limited to, a detailed view of the existing US legal entities,

a plan for the transition to the IHC structure and an implementation plan to meet various compliance requirements, as well as quarterly pro-forma financial statements and pro-forma regulatory capital ratios for the US IHC from 31 December 2015 to 1 January 2018 – including any planned capital actions necessary for the IHC to meet appropriate capital levels.

Details of other rule changes to specific EPS requirements

Consistent with the Federal Reserve's stated objectives to apply consistent standards to FBOs and BHCs, the Rule maintains the vast majority of the proposed requirements. Highlights of the key changes from the proposed rule are summarized to the right.

What should FBOs do now?

While the new timing for creating an IHC provides some breathing room, the largest FBOs are still faced with a demanding timeline for implementation and may need to adjust their planning and structuring efforts in light of the new formal Implementation Plan requirement.

Large FBOs should continue to examine options for corporate structures and operating models, being mindful of the new 1 January 2015 Implementation Plan deadline. The planning should evaluate how to optimize the IHC's and parent's capital, liquidity and tax implications (e.g., deferred tax assets, intangibles or assets with adverse risk weights) of these structural options against any early or additional compliance burden that may be invoked (e.g., using an existing BHC as the IHC). The FBO parent will need to consider where the IHC is placed within its global corporate structure and how its home country supervisor will treat the investment in the US IHC for the purpose of calculating parent company regulatory capital and other requirements.

FBOs should also commence work on the Implementation Plan. A number of items that need to be included may represent a significant work effort for organizations, such as:

- ▶ Completing the analysis of IHC structuring options – the Implementation Plan should include a mapping of the IHC structure, a detailed view of US legal entities that will be consolidated in the IHC, and a plan and projected timeline for transferring ownership to the IHC.
- ▶ Providing forward-looking quarterly pro-forma financial statements and pro-forma regulatory capital ratios for the US IHC from 31 December 2015 to 1 January 2018. Developing the pro-forma will require advancing decision-making on the structural approach to forming the IHC.

Many of the requirements in the Rule, such as stressed financial statement projection modeling for CCAR, have proved to be multiyear implementation efforts for the BHCs. The IHC requirements would have been challenging for FBOs to execute within the original time frame. Large FBOs that have been considering whether to deploy tactical processes, data and technology platforms under the proposed compliance dates may be able to evaluate the development of more robust and sustainable strategic solutions. However, with the longer compliance time frame, FBOs should be mindful that evolving supervisory expectations will likely "raise the bar." IHCs should plan for a depth and quality of risk management, capital and liquidity capabilities comparable with evolving standards and practices applied to the largest BHCs.

The timeline to execute a structural reorganization and to fully comply with the the Rule remains challenging. The time frame and deadlines have been finalized and FBOs need to quickly reevaluate initial plans in light of the Rule, begin work on the Implementation Plan, and press forward with implementation.

Topic	Final rule – Key changes and highlights
CCAR and stress testing requirements	<ul style="list-style-type: none"> ▶ IHCs are required to deliver a first capital plan and FR Y-14A reporting to the Fed, inclusive of stress test results, in January 2017. However, the first full public disclosure of IHC stress test results and independent Fed projections for IHCs will not commence until the next stress testing cycle, starting in October 2017. The final rule did not relax any of the US CCAR requirements for the IHC – Federal Reserve approval will still be required for all capital actions, including distributions to the IHC's parent. ▶ No specific timing is provided for the initial filing date for the FR Y-14M and FR Y-14Q schedules; this is expected to be addressed in future rule-makings. ▶ For BHC subsidiaries of FBOs that are currently operating under the Federal Reserve's SR 01-01 capital guidance, CCAR will apply to those BHCs in full, starting in October 2015, until the IHC enters the stress testing cycle beginning in October 2017.
Risk-based capital	<ul style="list-style-type: none"> ▶ The IHC will be required to comply with US Basel III market risk and standardized credit risk risk-weighted asset (RWA) rules. In a relaxation of the proposed standards, the Rule does not require IHCs to adopt the US Basel III advanced RWA measurement approaches for credit and operational risk. ▶ However, IHCs will be subject to the US\$250b asset and US\$10b foreign exposure thresholds, which will still trigger compliance with the Supplementary Leverage Ratio (SLR) and countercyclical buffer, and include Accumulated Other Comprehensive Income (AOCI) in Common Equity Tier 1 Capital Ratio (CET1) . ▶ Leverage ratio requirements (both the generally applicable ratio and SLR) will not apply to IHCs until 1 January 2018.
Liquidity requirements	<ul style="list-style-type: none"> ▶ Liquidity requirements are largely consistent with the proposal: FBOs are subject to extensive liquidity risk management and internal stress test requirements for both the IHC and US branches/agencies and for the combined US operations. ▶ The liquidity buffer requirement for branches and agencies has been reduced from 30 days to 14 days to cover net outflows. This is expected to be a marginal benefit, given that peak outflows frequently occur in the first 14 days. ▶ The preamble to the Rule notes that the forthcoming Liquidity Coverage Ratio (LCR) final rule will also likely apply to IHCs. If the US LCR is finalized as proposed, the US\$250b threshold would also be strategically significant as it would trigger a higher LCR requirement.
Risk governance	<ul style="list-style-type: none"> ▶ Overall requirements are largely unchanged from the proposed rule, with some limited modifications: <ul style="list-style-type: none"> ▶ Roles, responsibilities and expert member requirements for the US Risk Committee are clarified to differentiate between broad risk oversight by the Board and management responsibilities. ▶ The IHC risk committee can also serve as the US Risk Committee over the combined US operations, including branches/agencies. However, the FBO can also appoint a sub-committee of an FBO's Board Group risk committee to oversee combined US operations. ▶ The IHC's Chief Risk Officer (CRO) must have experience in identification, assessment and management of risk exposures at large, complex financial firms. The Rule also clarifies that the CRO must be employed by and located in a US entity.
Single Counterparty Credit Limits (SCCL)	<ul style="list-style-type: none"> ▶ SCCL requirements have not been addressed in the Rule. A separate rule for SCCL is expected at a later date in coordination with an agreement on standards from the Basel Committee on Banking Supervision.
Early remediation	<ul style="list-style-type: none"> ▶ Early Remediation Requirements have not been addressed in the final rule and are still under development.
Regulatory reporting	<ul style="list-style-type: none"> ▶ In contrast to the proposed rule, the Rule does not specify whether BHC regulatory reporting requirements also apply to IHCs. We expect all regulatory reports required by BHCs will be required for IHCs, and further clarification will be provided by the Federal Reserve on IHC reporting requirements.

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