The U.S. Federal Reserve’s Rules for FBOs and the Implications for IT Operations and Systems

The U.S. Federal Reserve Board’s recent rules for implementing enhanced prudential standards for large U.S. Bank Holding Companies and Foreign Banking Organizations will have a significant impact on IT Operations and Systems.

Executive Summary

The Federal Reserve Board recognizes that Foreign Banking Organizations (FBOs) play an important role in the U.S. financial sector, and that their presence has brought both competitive and counter-cyclical benefits to U.S. markets. However, the economic downturn that began in 2007 revealed that FBOs could pose risks similar to the ones demonstrated by large U.S. financial institutions. This is particularly relevant considering that many U.S. branches of foreign banks have shifted their model – from being a “lending branch” to doing business as a “funding branch.”

During a period of crisis, there is a very high chance that respective jurisdictions will impose restrictions on the movement of funds across borders. Under the existing regulatory framework, FBOs have structured their U.S. operations to ensure maximum efficiency of capital and liquidity management at the consolidated level.

This environment has set the context for rules issued by the Board of Governors of the Federal Reserve System (Fed Board) for implementing enhanced prudential standards for large FBOs. In December, 2012, the Fed Board invited comments on the proposed rules for large FBOs. The Board incorporated certain adjustments based on feedback from industry participants, and approved the final rules in February, 2014. The rules exclude early remediation requirements and the coverage for Foreign Non-Bank financial companies supervised by the Fed Board (Fed-FNBFCs). The Board intends to address these by issuing separate rules.

In this paper, we will review these proposed regulations – focusing on the effect they will have on FBOs’ IT operations and systems.

Enhanced Prudential Standards for FBOs

In December, 2012, the Fed Board proposed rules for implementing the amended prudential standards established under Section 165 and the early remediation requirements under Section 166 of the Dodd-Frank Act for FBOs and Fed-FNBFCs.

Later, on February 18, 2014, the Fed Board approved the final rules – allowing large domestic and foreign banks to apply the enhanced prudential standards required under Section...
165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). These rulings incorporated certain adjustments based on the comments received from various industry and market participants.

For a large FBO with total consolidated assets of US$50 billion or more, the rules cover enhanced leverage and risk-based capital requirements; requirements related to liquidity, risk-management and stress-testing; as well as a debt-to-equity limit for companies that the Financial Stability Oversight Council (FSOC) has determined pose a grave threat to the financial stability of the U.S. The prudential standards exclude the earlier proposed guidelines for single counter-party credit limits and the early remediation requirements. They do not impose the amended prudential standards on Fed-FNBFCs.

The rules also establish a risk-committee requirement for publicly traded FBOs with total consolidated assets of US$10 billion or more, as well as stress-testing stipulations for FBOs and foreign savings and loan holding companies with total consolidated assets3 of US$10 billion or more. Additionally, the rulings mandate that every FBO with U.S. non-branch assets of US$50 billion or more form a U.S. Intermediate Holding Company (IHC), which would serve as a U.S. top-tier bank holding company for its U.S. subsidiaries.

Factors Leading to Enhanced Prudential Standards

The profile of FBOs’ operations in the U.S. changed substantially in the period preceding the financial crisis. U.S. branches and agencies of FBOs went from receiving funding from their parent organizations on a net basis in 1999, to providing significant funding to non-U.S. affiliates by the mid-2000s. In 2008, these U.S. branches and agencies provided more than US$600 billion on a net basis to non-U.S. affiliates. Since the U.S. operations of FBOs received less funding (on net terms) from their parent companies over the past decade, they became more reliant on less stable, short-term U.S. dollar wholesale funding – contributing in some cases to a buildup in maturity mismatches. This structural diversity, along with consolidated management of capital and liquidity, has facilitated cross-border banking and increased global flows of capital and liquidity.

The growth in concentration, complexity and interconnectedness of FBOs’ U.S. operations and the lessons learned during the crisis have raised concerns about the stability of the U.S. banking system, since many branches of the FBOs have shifted from being “lending branches” to “funding branches” of foreign banks.

More importantly, the Congressional mandate included in the Dodd-Frank Act requires the Fed Board to impose amended prudential standards on large FBOs. Congress also directed the Fed Board to strengthen the capital standards applied to U.S. Bank Holding Company (USBHC) subsidiaries of FBOs by adopting the so-called “Collins Amendment” to the Dodd-Frank Act. Specifically, Section 171 of the Dodd-Frank Act requires a top-tier USBHC subsidiary of an FBO that had relied on Supervision and Regulation Letter 01-01 to meet the minimum capital requirements established for USBHCs by July 21, 2015.

The Impact on FBOs

FBOs with total consolidated assets of US$50 billion or more fall under the general scope of these rules. FBOs with U.S. non-branch assets of US$50 billion or more would be required to form a U.S. IHC that would be directly subject to the enhanced prudential standards. Figure 1 provides a summary of the rules that would apply to the FBOs.
Scope of Application of Rules for FBOs

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<th>Global Assets</th>
<th>U.S. Assets</th>
<th>Summary of Requirements</th>
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<tr>
<td>More than US$10 billion but less than US$50 billion.</td>
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<td>- Company-Run Stress Tests.</td>
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<td>- Risk Committee Requirements.</td>
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<td>- Risk-based and leverage capital requirements.</td>
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<td>- Risk management requirements.</td>
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<td>- Debt-to-equity limits (upon determination of grave threat).</td>
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<td>- U.S. IHC requirement (if the FBO has U.S. non-branch assets of US$50 billion or more).</td>
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Figure 1

Review of Proposed Regulations

- **Formation of U.S. IHC:** FBOs with total consolidated assets of US$50 billion or more and with combined U.S. non-branch assets of US$50 billion or more would be required to establish a top-tier U.S. IHC (in exceptional circumstances, multiple U.S. IHCs) to hold all U.S. bank and non-bank subsidiaries of the company, except for any company held under Section 2(h) (2) of the Bank Holding Company Act. The U.S. non-branch assets include all consolidated on-balance-sheet assets (other than assets held by a Section 2(h) (2) company or by a DPC branch subsidiary).¹

- **Capital requirements (risk-based and leverage):** These would be regulated at the U.S. IHC level and be similar to those applicable for U.S. BHCs. However, the U.S. IHCs will be exempt from the advanced approach rules of the U.S. Hence, capital adequacy will be addressed by standardized risk-based capital rules, as well as capital-planning and supervisory stress-testing requirements. Leverage capital requirements include the generally applicable leverage ratio of 4% for U.S. IHCs with total consolidated assets of US$250 billion or more, or total consolidated on-balance sheet foreign exposures of US$10 billion or more — the minimum supplementary leverage ratio of 3%.

  A U.S. IHC would be required to make public capital disclosures unless the FBO is subject to comparable public disclosure requirements in its home jurisdiction. Further, a U.S. IHC would have to submit an annual capital plan to the Federal Reserve. An FBO would have to certify that the capital adequacy standards at the consolidated (parent) level are consistent with the Basel Capital Framework.

- **Liquidity requirements:** This rule requires that an FBO with combined U.S. assets of US$50 billion or more establish a framework for managing liquidity risk, engaging in independent review and making cash-flow projections. The FBO should also establish a contingency funding plan and specific limits; monitor and stress-test its combined U.S. operations as well as its U.S. IHC and its U.S. branches and agencies (if any); and hold certain liquidity buffers.² For liquidity requirements, combined
U.S. assets are required to be computed as “Total combined assets of U.S. operations, net of intercompany balances and transactions between U.S. domiciled affiliates, branches and agencies.”

The rule limits concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers; the amount of specified liabilities that mature within various time horizons; and off-balance-sheet and other exposures that could create funding needs during liquidity stress events. The rule contains an internal monitoring requirement, which stipulates that FBOs establish and maintain procedures for monitoring intra-day liquidity risk of their U.S. operations. However, it does not require global cash-flow statements for activities conducted in U.S. dollars. The Fed Board will subsequently implement the quantitative liquidity standards included in Basel III (LCR, NSFR) through separate rulemakings. The liquidity stress-testing requirements mandate that the stress test be conducted at both the combined U.S. operations level and separately for U.S. IHC and U.S. branches and agencies of FBOs. Stress scenarios must also use a minimum of four time horizons, including overnight, 30-day, 90-day and one year. FBOs are expected to use their company-specific internal models for stress-testing requirements. The rule requires a U.S. IHC to maintain a buffer of unencumbered, highly liquid assets to offset net stressed cash outflows for the first 30 days in the U.S. The FBO’s U.S. branches and agencies would have to maintain a separate buffer for only the first 14 days in the U.S. While highly liquid assets predominantly include cash and securities issued or guaranteed by the U.S. government, a U.S. government agency or a U.S. government-sponsored enterprise, the rule allows other types of assets, provided the FBO is able to justify to the Federal Reserve that it has low credit and market risk, is actively traded in secondary markets, and was historically purchased by investors during periods of liquidity stress.

- **Stress testing**: This rule requires the FBO parent of a U.S. IHC to undergo a home-country stress-testing regime and to report the results to the Fed Board. A U.S. IHC must project its regulatory capital ratios in its stress tests without additional consideration of possible support from its home-country parent. It would be subject to reporting obligations in connection with its company-run and supervisory stress tests, and would be required to publicly disclose the results of the company-run stress tests. In addition to a U.S. IHC, an FBO with combined U.S. assets of US$50 billion or more would have to submit key information regarding the results of its home-country stress tests. If an FBO doesn’t meet the stress-testing standards, the Board would mandate that its U.S. branches and agencies, as applicable, maintain eligible assets equal to 108% (105% if combined U.S. assets are more than US$10 billion but less than US$50 billion) of third-party liabilities, calculated on an aggregate basis. FBOs with total consolidated assets of more than US$10 billion but less than US$50 billion, and foreign savings and loan-holding companies with total consolidated assets of more than US$10 billion, are allowed to use home-country stress tests.

- **Risk management**: An FBO with any class of publicly traded stock and total consolidated assets of US$10 billion or more, and any FBO (regardless of whether its stock is publicly traded) with total consolidated assets of US$50 billion or more would be required to certify that it maintains a U.S. risk committee on its board of directors or equivalent home-country governance structure. This provides a certain degree of flexibility for FBOs to establish their U.S. risk committee as either a committee of their home offices or of U.S. IHCs. In addition, FBOs with combined U.S. assets of US$50 billion or more would be required to adhere to additional risk-management rules, such as appointing a U.S. Chief Risk Officer and an independent member in the U.S. risk committee.

Once the Financial Stability Oversight Council determines that an FBO poses a “grave threat” to U.S. financial stability, the Fed requires the FBO to limit its debt-to-equity ratio to 15-to-1 on its U.S. IHC and any U.S. subsidiary not organized under a U.S. IHC (other than a Section 2(h)(2) company). It also mandates 108% asset maintenance on its U.S. branches and agencies as an equivalent to a
debt-to-equity limitation. The rules don’t impose a cap on cross-border intra-group flows, thereby allowing FBOs in sound financial condition to continue to obtain U.S. dollar funding for their global operations through their U.S. operations.

Getting There
The Fed Board is proposing a substantial phase-in period to give FBOs time to adjust to the new rules. FBOs that meet or exceed the asset threshold on July 1, 2015 will be required to meet the new standards (including the U.S. IHC requirement) by July 1, 2016 (extended by a year due to concerns raised during the comment period). For FBOs that meet the criteria after July 1, 2015, the rules require compliance beginning the first day of the ninth quarter (effective compliance period of two years) after the FBO meets or exceeds the threshold.

By July 1, 2016, a U.S. IHC must hold its FBO’s ownership interest in any U.S. BHC subsidiary and any depository institution subsidiary, as well as in U.S. subsidiaries representing 90% of the FBO’s assets not held by the bank holding company or depository institution. The rule gives an FBO until July 1, 2017, to transfer its ownership interest in any residual U.S. subsidiaries to the U.S. IHC.

A U.S. IHC formed by July 1, 2016 will be required to submit its first capital plan by January 2017. Consistent with the Basel III transition period, the rule delays application of the generally-applicable leverage ratio to U.S. IHCs until January 1, 2018. The debt-to-equity ratio limitation would be in effect on the effective date of the final rule.

Impact of the Regulations
The approved rules have significant and wide-ranging implications for foreign banks and financial institutions:

Business Strategy and Operational Impact
The FBO regulation will be a key driver for the business strategies of the FBOs in the U.S. Most institutions will probably choose to grow cautiously, while others may decide to reduce their presence in the U.S., since they are likely to see an increase in compliance costs. Some of the key areas that will impact the business strategy and operations are:

- **Governance:** Firms may need to establish a separate board of directors (or equivalent), a Chief Risk Officer and additional risk committees to demonstrate the autonomy and accountability of the U.S. IHC to the regulators. To conform to these requirements, firms may have to undergo organizational restructuring and consolidation of business entities across lines of business (such as asset management, capital markets, insurance, etc.).

- **Cost of operations:** Financial institutions may experience an increase in operational costs as they build their ability to operate independently at the U.S. IHC level (like restructuring operations to transfer subsidiaries to the U.S. IHC, revising trade-related and employment contracts, reallocating assets, etc.). They will also need to make additional investments in their technology infrastructure to support the new governance, reporting and compliance requirements. Tax costs, if any, would be over and above these expenditures.

- **Risk policy:** Financial institutions will be required to hold additional capital and liquidity buffers at the U.S. IHC level, resulting in an increase in the cost of capital. Moreover, the liquidity buffer should include HQLA as defined by the U.S. Fed, which at the moment only includes instruments issued by the U.S. government or government-backed entities. Other factors, such as building contingency plans in case intra-group funding dries up, might further drive up costs. These additional expenditures will be a negative factor on the return on equity for investments in the U.S.

The Impact on IT Operations and Systems
Any impact on business strategy and operations will have an impact on the bank’s associated technology operations. Figure 2 provides a review of the key IT focus areas.
## IT Impact of FBO Regulations

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<th>IT Group and Reference Data</th>
<th>Impact</th>
<th>Applicable Guideline</th>
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<tbody>
<tr>
<td><strong>Operational and Reference Data</strong></td>
<td>Build the ability to integrate and monitor financial information at the U.S. IHC level. This may require firms to review their legal entities and account hierarchy relationships across various business lines.</td>
<td>Formation of a U.S. IHC</td>
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<tr>
<td><strong>Analytics and Reporting</strong></td>
<td>Develop additional reporting capabilities for large organizations to comply with BIS and FSOC SIB (Systemically Important Banks) regulations and various additional reports related to structural changes, country exposure reports, consolidated reports, etc.</td>
<td>Formation of a U.S. IHC</td>
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<td>Integrate limits-monitoring systems across business lines to help ensure the ability to aggregate information – monitor, assess and report concentrations in sources of liquidity risk, maturity time horizons of liabilities, and on-and off-balance sheet exposures, etc.</td>
<td>Liquidity Requirements.</td>
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<td><strong>Risk Technology</strong></td>
<td>Assess and enhance systems to aggregate and monitor the risk at the U.S. IHC level. This would involve ensuring the ability to slice-and-dice data against key parameters such as books, regions, legal entities, business lines, currencies, etc., as well as configure the systems to accept multiple values of key inputs (like surcharges, buffers, haircuts, projected cash flows, valuations, discount factors, shocks, etc.).</td>
<td>Formation of a U.S. IHC</td>
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<td>Build a centralized collateral-management system with the ability to assign and lock the collateral at the U.S. IHC level to maintain separate liquidity buffers globally and at U.S. IHCS. This requires streamlining the systems across various businesses to help ensure consistency in the information attributed to various assets, such as location of the asset, netting agreements, gross vs. net recordings (applicable netting rules might be different), maturity computations (trade date basis vs. settlement date basis, day count convention, actual vs. effective maturity, etc.).</td>
<td>Liquidity Requirements</td>
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<td>Improve system capabilities to apply various models (e.g., foundational and advanced approaches for capital computation) on subsets of operational data, and account for differences in the Basel implementation guidelines in the home country (parent/group level) and in the U.S.</td>
<td>Capital Requirements</td>
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<td>Assess the impact of the recently finalized U.S. Basel III liquidity requirements on the current liquidity reporting infrastructure and its ability to project liquidity cash flows and report liquidity metrics (LCR, NSFR) for the U.S. IHC, including generating liquidity stress reports. For example, equity exposures have a granular assignment of risk weights in the Fed’s U.S. Basel III compared to OSFI guidelines.</td>
<td>Liquidity Requirements</td>
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<td>Gauge the ability to globally generate regulatory and stress scenario results; the U.S. IHC systems might require enhancements to accept and act on the inputs from regulators for supervisory stress-testing. This would require the ability to aggregate and report risk sensitivities, scenarios and P&amp;L results by the U.S. IHC legal entity framework.</td>
<td>Stress-Testing Guidelines</td>
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Figure 2
Looking Ahead: Increasing Mandates

So far, regulation of foreign banks in the U.S. has been performed on an ad-hoc, or “case-by-case” basis. After a decade of inaction, the approved FBO rules represent sweeping changes, and are thought to be consistent with the Federal Reserve’s longstanding policy of national treatment and equality of competitive opportunity between the U.S. operations of FBOs and U.S. banking firms.

While critics of these guidelines argue that the U.S. did not experience a destabilizing failure of FBOs during the global financial crisis, preventive actions are nonetheless needed, especially given today’s global economic scenario. Clearly, the proposed regulations would help ensure the 3Cs — consistent, consolidated and comprehensive application of the rules for FBOs operating in the U.S. This would place all banks operating in the U.S. on an equal footing. Of course, the logical fallout could lead regulators in other countries to follow suit by making cross-border operations more complex and costly. Furthermore, critics argue that regulatory consistency among parent and host countries would be lost if these regulations are implemented.

A U.S. IHC structure would create a platform for consistent supervision and regulation of U.S. operations of FBOs, and help facilitate the resolution of failing U.S. operations of a foreign bank if needed. Certain industry participants questioned the authority, appropriateness and necessity of this onerous prudential standard. The Board justified it by citing consistency of regulation across U.S. non-branch operations of FBOs during the global financial crisis, preventive actions are nonetheless needed, especially given today’s global economic scenario. Clearly, the proposed regulations would help ensure the 3Cs — consistent, consolidated and comprehensive application of the rules for FBOs operating in the U.S. This would place all banks operating in the U.S. on an equal footing. Of course, the logical fallout could lead regulators in other countries to follow suit by making cross-border operations more complex and costly. Furthermore, critics argue that regulatory consistency among parent and host countries would be lost if these regulations are implemented.

We believe that the proposed capital and leverage requirements will help bolster the consolidated prudential standards for FBOs.
capital positions of the U.S. IHCs and promote equal footing for all banks operating in the United States. The liquidity requirements will help make the U.S. operations of FBOs more resilient to funding shocks during times of stress.

The complex and varied organizational structures in the current corporate world will pose challenges when it comes to defining the precise scope of these regulations. One example is Foreign Parallel banks. The current proposals would not cover these banks, where common ownership is established through people or their agents, rather than through direct corporate structures.

The new rules will be closely watched over the next couple of years, especially if other countries initiate similar regulations to protect their financial system.

Footnotes
1 For the purpose of this document, a foreign banking organization is a foreign bank that has a banking presence in the United States by virtue of operating a branch, agency, or commercial lending company subsidiary in the United States or controls a bank in the United States or controls an edge corporation acquired after March 5, 1987; or any company of which the foreign bank is a subsidiary. (http://www.law.cornell.edu/cfr/text/12/211.21)
3 U.S. non-branch assets are equal to the sum of the consolidated assets of each top-tier U.S. subsidiary of the FBO (excluding any Section 2(h) (2) company and DPC branch subsidiary, if applicable). For the purpose of this document, it is calculated as the average of the U.S. non-branch assets for the four most recent consecutive quarters, as reported to the Board on the FR Y-7Q, or, if the FBO has not reported this information on the FR Y-7Q for each of the four most recent consecutive quarters, the average for the most recent quarter or consecutive quarters as reported on the FR Y-7Q. p17327 Federal Register/ Vol. 79, No. 59 / Thursday, March 27, 2014 / Rules and Regulations, 12 CFR Part 252 (http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf)
6 http://www.law.cornell.edu/uscode/text/12/1841
7 DPC branch subsidiary is defined as a subsidiary of a U.S. branch or a U.S. agency acquired, or formed to hold assets acquired, in the ordinary course of business and for the sole purpose of securing or collecting debt previously contracted in good faith by that branch or agency.

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