Analysis

Intercompany Loans

Regulatory Reform in the Financial Industry And End-to-End Transfer Pricing Execution

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The recent financial crisis made clear to the world that the current operative regulatory rules and oversight were ill-suited to the way financial markets have evolved. And that reform was long overdue. Undoubtedly regulatory reform is a global agenda addressing multiple fronts. Countries active in the global financial markets have been taking measures to improve the controls governing the capital markets, with the immediate objective of protecting their own economy and fiscal health. These measures include improving transparency in securities trading among market participants and individual investors as well as tightening legal entity accounting and valuation protocols within a global institution. The U.S. has certainly been the most assertive and prescriptive in pushing legislation around these measures.

How will regulations affect banks’ global capital usage and other operations?

When the Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law in 2010, banks as well as non-bank financial institutions braced themselves and started to devote significant resources to preparing for the significant fundamental changes to their compliance, reporting and operational structures. The U.S. was the first to adopt such broad regulatory reform into law, but other countries are fast on its heels, with provisions regarding capital
requirements, ring-fencing and other measures. Whether these separate country initiatives will converge into a consistent and common regulatory landscape in application is undetermined. Regulatory capital requirements will be uniformly increasing under Basel III and some countries will be going beyond Basel III requirements. However, local regulatory definitions of types of capital that meet the various tiers or the risk-weighting of assets are still in flux with potential inconsistencies that banks now need to consider in optimizing their global capital usage.

One thing that is evident is that institutions need to tighten up on controls, process and execution of their governance policies, not least of which relates to their intercompany arrangements and dealings.

One of the chief impacts of these measures in the emerging regulatory environment is the requirement of institutions to reliably and accurately produce separate legal entity reporting of their financial positions on an ongoing basis. The ability to generate stand-alone legal entity financial statements is the cornerstone of an institution's ability to comply with the various regulatory changes around the world. But this is an area in which many financial institutions have considerable process and system challenges. Many have seen acquisitions as a means to achieve their growth strategies, which have led to managing different types of legacy systems—whether at source data level or reporting platforms—without having properly and fundamentally reconciled these disparate systems. Global financial institutions have highly integrated operational structures heavily reliant on shared technology, operations, management and other critical infrastructure across multiple legal entities. Historically, they have not always applied the same level of diligence in accurately processing their intercompany arrangements as they do for third-party transactions, despite the fact that for many overseas subsidiaries of U.S. financial institutions intercompany transactions represent the greater part of their income.

**Regulatory reform’s impact on intercompany arrangements**

The clearest manifestation of regulatory reform’s impact on intercompany arrangements originated in the U.S. through specific provisions of Dodd-Frank. The U.K. has also recently enacted a rule requiring a nominated “senior accounting officer” to verify that financial statements reflect appropriate tax accounting arrangements. As other countries continue their own local agendas, a closer examination of these recent laws is mandatory in evaluating whether an institution is capable of reporting under these new standards.
This analysis begins with a review of the specific key provisions under Dodd-Frank for which successful compliance with the new regulatory requirements is acutely affected by the institution's operational execution of intercompany and affiliate transaction pricing policies. Often transfer pricing policies have been viewed in isolation as a cross-border tax matter with an occasional nod to its U.S. regulatory equivalent—the Federal Reserve's Regulation W implementing Sections 23A and 23B of the Federal Reserve Act. However, there is now wider recognition that the tax and regulatory governance of intercompany arrangements needs to be reconciled, both from a policy as well as an execution perspective.

**Impact of Dodd-Frank**

At the heart of Dodd-Frank is the need to ensure that a regulated institution is adequately capitalized and that it is sufficiently protected from risk that is created or borne by affiliates. All roads therefore lead to the following fundamental question regarding separate-entity reporting of the affected regulated entities and the operational framework: Are the assets, liabilities, revenues and expenses reported by the regulated entity complete, appropriately valued and appropriately classified?

For third-party dealings, the general accounting rules and regulations tend to ensure appropriately transparent accounting and operational processes as a general matter. However, the strict processes, procedures and discipline around external market transaction accounting and disclosures have often not been carried through to intercompany and affiliate dealings. An extreme scenario, which is not uncommon among some of the largest and most complex institutions, is one in which all intercompany transactions are captured and accounted for on a net basis through a single below-the-line intercompany settlement account irrespective of the nature of the intercompany arrangement—often with poor audit trails back to the source. Not least of the distortions created by this simplified accounting is that on a gross basis, a firm's assets, liabilities, revenues or costs are understated. This has immediate implications on the same inputs that drive capital requirement calculations.

A few factors have created the more lax operational environment around intercompany transactions as compared to external transactions:
• The increasing centralization of operations within most multinationals has created a less direct accounting link between the costs incurred by the firm and the ultimate end-user business unit or legal entity that might rely either directly or indirectly on these centralized resources. In turn, there has been a vast increase in cost centers that require active mapping and profit or revenue center allocations. Further, various entities might serve as this operational or management hub, and therefore an end-user of one service is a provider of another.

• Many firms are measured more on management reporting that is legal-entity neutral (that is, based on a region or a business segment) than on separate legal entity results. This has deemphasised the need to understand legal entity relationships and to ensure that transactions are fully recognised and recorded at the local statutory levels.

• To date, statutory audit and accounting governance has focused on controversial accounting methods such as Repo 105\(^3\) rather than on intercompany transactions with the proviso that they should completely eliminate at top-level consolidations, notwithstanding that local statutory financial statements would reflect their side of the offsetting accounts.

As a result, as firms try to align their operational, governance and control infrastructure to comply with Dodd-Frank and other regulatory requirements, the status of an institution’s intercompany and transfer pricing policy execution framework has become one of the primary areas of focus.

There are a few key initiatives and provisions within Dodd-Frank in particular for which the level of intercompany and transfer pricing operational framework is most visible. The initiatives to be discussed in this article are:

• capital requirements,
• resolution and recovery plans and
• swaps and derivatives push-out rules.

**Bank capital requirements**

Adequate capitalization of a legal entity is based on the riskiness of the assets and liabilities on—and in some cases, off—its balance sheet and the stability of the revenues it derives and
costs it bears to drive its profitability. For a regulated entity that relies significantly on its affiliates for revenue, services and balance sheet usage, the accurate execution of the intercompany dealings is essential to the question of the required level of capital for that entity if valued on a pure, stand-alone arm's-length basis in which all the support provided by its affiliates (or that it is providing to other affiliates) are appropriately measured and reported on the balance sheet and income statement.

**Resolution and recovery planning**

Resolution planning requires that large U.S. banking organizations and certain designated systemically important non-bank financial companies submit to the regulators on an annual basis a resolution plan for their market-facing regulated entities under a hypothetical failure scenario. Usually the plans include courses of action for recapitalization, disposals or bankruptcy. In any of these scenarios, being able to provide accurate separate-entity financial positions is critical to the efficacy of the plan. Given that most regulated entities generally rely heavily on resources not directly within the control or sponsorship of that entity, a significant element of their financial position is driven by its intercompany dealings—including the need to capture service fees and cost allocations due to services being provided by an affiliate. Therefore, it is essential that the intercompany policies in place are implemented and executed correctly.

The execution includes ensuring not only that the correct costs and revenues are included in the calculations, but that the legal agreements are explicit about the nature of the services or goods being made available along with the risks. The exercise of preparing a resolution plan starts with a hypothetical scenario of being cut off completely from the support of affiliates. What are the operational, financial and management support functions that must now be provided by an external party—and at what price would the regulated entity be charged? Once these dependencies are identified, the existing intercompany transactions should naturally already be priced and settled at arm's length and properly reflected on a stand-alone basis today.

**Swaps and derivatives push-out rule**

Under the swaps push-out rule of Dodd-Frank, U.S. banks are required to push out certain swaps and derivative activities to non-bank affiliates subject to Regulation W requirements.
This raises two scenarios regarding intercompany arrangements:

- a one-time intercompany transfer of the associated business or assets and
- potentially new or revised intercompany arrangements.

The question of a one-time intercompany transfer of a business or assets requires appropriate valuation of the related business or assets. As most assets, especially financial instruments, are generally accounted for on a mark-to-market basis, this should not be a significant issue. However, if there is a transfer of a broader business, then one must consider a more holistic valuation of the business itself, which includes identifying the projected cash flows that account for prospective intercompany services expected to be performed. Generally, projections rely on past and current actual levels of costs and revenues, and therefore it is important to ensure that current execution of transfer pricing policies have resulted in accurate charges and service fees so that the projections built on historic figures are reliable and not distortive to the overall valuation.

Similarly, when a segment or business is transferred from one legal entity to another, new intercompany arrangements may be created due to the fact that some of the activities in support of the swap business that formerly were carried out by the same legal entity will not or cannot migrate with the swap trading activities. Therefore, these new intercompany services will need to be identified, priced and ultimately executed appropriately to ensure that the separate-entity reporting of the business is accurate and complies with regulatory requirements.

**Arm's-Length Pricing: 'Reg W,' Section 482**

There has always been a natural overlap between the regulatory oversight of bank transactions with affiliates and the rules governing related-party pricing for tax purposes. The tax world has regulations under Internal Revenue Code Section 482, while the U.S. banking regulatory world has Regulation W implementing Sections 23A and 23B of the Federal Reserve Act. There are a few nominal but real differences between the two in their respective historic applications, the most notable being that the Section 482 regulations generally provide a multi-party evaluation of the arm’s-length pricing from the perspective of all participants to the transaction, whereas Section 23B is usually one-sided, from the perspective of the regulated entity only. That is, the
bank transaction is on pricing terms that are at market rates or better, irrespective of results to the non-bank affiliate.

A brief background and history of each would be helpful to understanding why this coincidence and overlap has evolved into an outright convergence of principles and governance across the two regimes since Dodd-Frank.

Sections 23A and 23B make clear that the primary concern of regulators is to ensure that an entity is not, by virtue of its dealings with its affiliates, inadvertently exposed to its affiliates’ financial and operational risks. Section 23A has a long history and is basically intended to ensure that banks are not unduly exposed to credit risks arising from transactions with affiliates. Section 23B has a much shorter history and is intended to ensure that a bank’s service and other transactions with affiliates are on market terms and conditions. The purpose of Section 23B is to ensure a bank is not using service contracts as a way to unfairly shift costs of operations to the bank, which can be financially damaging to the bank and a means for non-bank affiliates to price more aggressively than their competitors. Much of Sections 23A and 23B focus on enumerating financial and securities dealings with affiliates as greater concerns of the regulators.

With Dodd-Frank as the catalyst, affiliate service transactions have become much more prominent as entities work on provisions such as resolution planning. Resolution planning forces regulated entities to imagine being completely cut off from affiliates. What management, operational, administrative, infrastructure and other types of support would they now need to contract with third parties under third-party terms and conditions? In this context, it is then expected that market prices and terms should already be reflected in the prices and terms for all of the affiliated service transactions and relationships in place today. Further, as an entity regulated under the one regulatory body such as the Federal Reserve may be transacting with another entity that is regulated under another agency such as the Financial Industry Regulatory Authority or the Commodity Futures Trading Commission with similar expectations of market pricing in affiliate transactions, the axiom of “market price or better” is compressed into “market prices,” with less bandwidth for a one-sided evaluation. Similarly, other bank regulatory bodies such as the Office of the Comptroller of the Currency and the Federal Deposit Insurance
Corporation have an expanded role under Dodd-Frank to interpret and apply Sections 23A and 23B to arm's-length transactions between banks and non-bank affiliates.

A bank's transfer pricing compliance process on its cross-border related-party transactions is the obvious and ready platform for regulatory compliance on affiliate transactions. For starters, the Section 482 regulations are vastly more rigorous than Reg W, Section 23B in the requirements to substantiate the arm's-length nature of related-party transactions. The Section 482 regulations provide for specific methods that can be applied in evaluating these transactions and require that the taxpayer consider the appropriateness of each method before selecting the best method to apply.

Section 23B does not elaborate further than the requirement that affiliate pricing should be comparable to market prices. How exactly a bank can go about substantiating the market value of its affiliate pricing arrangements is not addressed. As a result, banks' historic experiences with regulators on this issue, according to anecdotal evidence, have been inconsistent and unpredictable. Banks' more recent experience speaks to more proactive scrutiny of affiliate service transactions with a dramatic uptick in requests for supporting documentation and analyses. No longer are regulators satisfied that some charge has been made and that the results are not unfavorable to the bank. They want the assertive analysis that the value of the charge is comparable to what would occur in a third-party arrangement and have started to more fully align, intentionally or unintentionally, with the provisions and standards of the Section 482 regulations.

Therefore, a bank's existing transfer pricing policies and governance process to address cross-border transactions is the natural starting point to see how these can be extended and applied to affiliate transactions involving regulated entities, whether domestic or cross-border. And even more critical to regulatory compliance is the execution framework once transfer pricing policies have been established.

**U.K. senior accounting officer provisions**

In 2009, the U.K. introduced senior accounting officer (SAO) rules that require qualifying companies to nominate an SAO that is personally responsible for taking “reasonable steps to ensure the qualifying company establishes and maintains appropriate tax accounting
arrangements.” Within the rules, tax accounting arrangements are described as the end-to-end process “from the initial data input into accounting systems to arriving at the numbers which form the basis for completion of the tax return.”

In 2012, following revisions to the original rules, banks were brought within scope of the SAO rules such that today, banks with sizable U.K. operations are likely to qualify and be required to certify compliance with the SAO rules each year.

Many banking institutions will have transfer pricing policies that cover material cross-border transaction flows. The implementation of these transactions may involve tax accounting arrangements that span multiple jurisdictions and require data from several information sources. The complexity of these arrangements mean transfer pricing execution is becoming increasingly important for banks operating in the U.K. that are required to comply with SAO rules.

**Transfer pricing execution framework**

It is therefore growing increasingly important for financial institutions to be able to “prove out” the implementation or execution of the policy in their books and records. This step is an integral part of the end-to-end processes and data flows that take a transfer pricing strategy all the way through to local financial statements and tax returns. This end-to-end execution is even more important for regulated entities in their reporting for intercompany transactions.

The increasing importance of legal entity governance continues to put transfer pricing execution higher on the agenda of executives and controllers. Where a unilateral focus was historically allowed, institutions are now faced with the requirement to look at transactions from all angles and provide arm’s-length support for each participant. Add to this the lack of underlying execution groundwork and systems support, and financial institutions are faced with an extremely challenging time with significant constraints.

In some instances the issue may be even more acute—for example, in locations where the majority of the activity is intercompany, with little third-party activity. This results in jurisdictions where the impact of inaccuracies in transfer pricing execution for one transaction may result in material errors and restatements. The difficulty in managing this level of vulnerability can affect a company’s effective tax rate.
Execution risks

Large financial institutions in particular have built up constraints and obstacles over time due to the highly complex nature of their operations. These transfer pricing execution challenges often have not reached an audience outside of the tax department. The various financial reporting systems used for controllership purposes are often not adequately or optimally designed to source and aggregate the types of data required to identify and process intercompany transactions. Since most firms are more concerned with accuracy of financial reporting at the consolidated level, governance on separate legal entity accounting for the various intercompany transactions often is lax or nonexistent, resulting in journal entities and accounting treatment for the resulting flows. Intercompany balances may or may not be properly settled on a timely basis, which can distort balance sheets through semipermanent receivables and payables balances.

Improper governance around intercompany flows presents a variety of execution risks. To illustrate how this risk can play out and potentially snowball, consider the impact from local affiliate perspectives. Local profitability in some locations of the firm may be highly or exclusively dependent on intercompany relationships, the proper execution of policies, and the appropriate reporting of revenue and expenses on local statutory books and records. Along those lines, if transfer pricing policies are otherwise designed to properly allocate profits and losses to affiliates operating in multiple countries with different tax rates, improper execution leaves incorrect local taxable income bases and therefore can affect a firm's global effective tax rate. This can also affect deferred tax assets.

Symptoms of transfer pricing execution challenges

Transfer pricing execution difficulties stem from a number of sources. When multiple difficulties are present in one instance, the uphill battle to execute transfer pricing policies can be exhausting and frustrating. As outlined earlier in this article, the picture is similar for large financial institutions trying to ensure their intercompany and affiliate pricing is executed accurately.

Some typical symptoms of intercompany execution challenges include:
• “hero dependency”—the overreliance on key individuals—in tax and accounting or controllership;
• a patchwork of data sources and Excel spreadsheets, and concern that enterprise and resource planning system do not provide sufficient functionality to adequately maintain and monitor the transfer pricing results;
• undocumented interpretations of ambiguous terms in intercompany agreements;
• informal process hand-offs relying on goodwill and personal relationships, which create multiple manual processes;
• quarterly or annual close processes creating frustrations for tax, controllership and information technology;
• transfer pricing results themselves that are not consistent from period to period and cannot be easily explained, which mean that effective tax rate forecasts are hampered by lack of information at the entity or country level; and
• “near misses” and concern about the Sarbanes-Oxley controls position.

Where to begin

Companies can establish a more strategic approach to managing intercompany processes that moves beyond typical ad hoc activities and manual data collection and also aligns all relevant control groups to more effectively monitor and implement intercompany policies and procedures. Successful companies focus on the people, process, and technology aspects to bring their organizations into alignment around the relevant transactions and processes.

For banks and other regulated institutions, this means a renewed focus on developing a transparent and collaborative team that works towards the same goal while achieving personal goals along the way.

The value to be realized

The more efficient and aligned the functions involved in executing intercompany pricing that feed into local statutory accounting, the more value can be realized. Examples of value typically observed include:

• statutory and regulatory requirements that are met in a more timely and efficient manner,
• reduced audit risks,
• better internal tax controls,
• a faster close process,
• automated and standardized data collection processes and transfer pricing calculations,
• rationalized IT and systems investment,
• decreased costs of audit defense,
• improved cash tax management,
• a completed transfer pricing scenario analysis, and
• reduced indirect tax compliance costs.

**Conclusion**

Today's financial institutions operate in a highly integrated manner across multiple regions and functional groups, and ultimately across the branches and legal entity subsidiaries in which they operate. This has resulted in greater reliance on one another among branches and separate legal entity subsidiaries for capital, infrastructure and operational support. Not least of the affects of banking reform is the heightened need for end-to-end processes that are complete, reliable and sustainable to ensure accurate and complete execution of intercompany pricing policies. Therefore, as a financial institution navigates through the ongoing changes in the regulatory landscape, in developing strategy and planning for regulatory compliance and optimizing capital usage across the globe, all control groups within the institution—legal, regulatory, treasury, finance and controllership as well as tax—require an active seat at the table.

So what does this mean for the financial institutions’ current efforts?

One immediate opportunity is to *get more out of what you are already doing*. For starters, financial institutions have already been doing a lot since the early winds of regulatory reforms were felt post-2008. These efforts have included, among others:

• legal entity rationalizations,
• business unit realignments and migration,
• diagnostics of systems capabilities and constraints and
• modification or new builds of financial systems including revised or new reporting hierarchies and improved integrity of source data flows. Given how highly dependent regulatory compliance might rest on accurate and efficient execution and reporting of intercompany transactions, proactively considering and implementing intercompany as well as third-party transactions in the existing work streams is both necessary and highly beneficial. In addition, such activity might involve only incremental supplementing of the existing resources and expenses relative to the size of the overall investments.

Below are just a few examples of how including transfer pricing as an important stakeholder and sponsor in aspects of regulatory reform initiatives can optimize the results from the large investments currently being made in the way of internal resources, costs incurred for infrastructure changes and use of external advisers:

• Identifying opportunities to improve accuracy and efficiency in intercompany pricing data sourcing, calculations and reporting. This may include transfer pricing input into the definition of profit and cost center attributes, mapping or hierarchies by legal entities at the source data level.
• Expanding, modifying or designing reporting capabilities to improve transparency of intercompany transactions. This may include trying to automate as much as possible the aggregation of certain data, calculations processed directly in the system and providing analytics for more efficient and flexible sensitivity analyses to monitor intercompany transactions and impacts on each legal entity.
• Expanding, modifying or designing the overall policies and processes governing intercompany pricing calculations, journal postings and reporting. These should include unambiguous sets of policies, roles and responsibilities across all the relevant control groups such as tax, business unit and legal entity controllerships, regulatory, treasury and legal departments. Continued governance in the development of segmented legal entity reporting and implementing appropriate procedures around this process ensures that the value of the initial investment and control level are realized and optimized over the long run.

In this regard, the authors suggest that the institution formally include transfer pricing policy execution and accounting as an objective of regulatory reform project plans due to the natural
synergies mentioned above. Tax, transfer pricing and intercompany accounting control teams should be involved at the appropriate stages throughout the life cycle of these projects to assist in defining data and reporting requirements, and ongoing process and governance procedures.

The authors have assisted with and witnessed the short-term and long-term benefits of strategic alignment of resources, budgets and objectives on infrastructure to meet multiple objectives. As advisers actively working with institutions in their respective response to regulatory reform and compliance efforts, the authors view the work currently being undertaken on financial reporting institution reporting as a natural and critical opportunity to embed the data, reporting and control requirements around intercompany transactions.

**Footnotes**

1In addition to risk-based capital requirements, U.S. regulators are proposing a higher leverage ratio for the eight largest U.S. bank holding companies that have been identified as global systemically important banks and their FDIC-insured bank subsidiaries at 5 percent and 6 percent, respectively. See Crittendon, Michael, “Plan Reins In Biggest Banks: Proposal Requiring Extra Capital Would Force Firms to Be More Conservative or Shrink,” *Wall Street Journal*, July 9, 2013.

2These provisions govern transactions by a U.S. bank with its affiliates.

3Under Repo 105, a short-term deposit is classified as a sale, and the resulting cash is used to pay down debt. This allows the company to appear to reduce its leverage for purposes balance sheet reporting. After the reports are published, the company borrows cash and repurchases its original assets.

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