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FATCA – The need for product assessment

VIEWPOINT

Overview of FATCA

The Foreign Account Tax Compliance Act (FATCA) was introduced by the United States in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act to prevent offshore tax evasion by US citizens and to improve tax compliance. Foreign Financial institutions (FFIs) will need to report to the IRS the US accounts they handle i.e., financial accounts held by U.S. taxpayers (even if they hold only non-U.S. assets) or held by foreign entities in which U.S. taxpayers hold a substantial ownership interest or be subjected to 30% withholding tax on any US-sourced income and sales proceeds. The primary obligation of the participating FFIs is to identify the products and customers that fall under the scope of FATCA withholding and reporting.

What is product assessment?

Product assessment is required to analyze the products offered by financial institutions to its clients and to avoid unintended impact of FATCA on the product universe. The assessment validates the way a product is offered to a client, as FATCA impact on a product is based on the client's location and generation of US-sourced Fixed, Annual, Determinable, Periodic (FDAP) income. This makes it necessary to evaluate the entire product base of all financial institutions.

What are the key steps for product assessment?

The process begins with defining the product base of the financial institution and eliminating the inactive products from further assessment. This includes product data extraction and identification of the affected products for their respective line of business. Post identification of the products, the products will be validated for its income generating capability and its geo locations. As a result of this process a structured list of FATCA affected products are derived. Each business entity of a financial institution is assigned a FATCA status. Based on the status, the in-scope products are addressed depending upon their FATCA impact.

What are the benefits and challenges faced?

The process of product assessment enables organizations to analyze the impact at a very basic level, which is essential for FATCA decision-making. It enables banks to identify FATCA-impacted products and establish processes that will ensure compliance for new products. Identification of critical products and the associated risks drive banks to adopt FATCA compliant processes and avoid unintended economic impacts.

Challenges

The potential challenges of product assessment:

- Accurate assessment associated with products and services
- Inputs from various functional units such as risk, audit, compliance etc., to gather relevant information
- Understanding local and global regulations and the spread of product offerings across various geos
- Identifying the expertise needed to effectively manage and analyze the product

As part of the due diligence process, the above mentioned challenges have to be mitigated. Financial institutions will have to identify the business units and systems from which accurate product data has to be derived for assessment. It strengthens client relationships as product assessment helps banks to understand and communicate the product suitability based on client type and the potential withholding and reporting process associated with the product.

Real-time scenarios

For interest and dividend offering products like fixed deposit, term deposit and money market accounts, it becomes straight forward that the income generated is withheld for applicable clients. But, that is not the case with products like interest rate derivatives that are used as hedges by financial institutions to combat fluctuations in market interest rates. Considering a swap arrangement, one of the parties pays out the interest based on fixed rate and earns the interest based on floating interest rate. Similarly, the other party pays out the interest based on the floating interest rate and receives the interest based on fixed rate. Situations like these makes interest disbursement and applicable withholding complicated. The core banking systems should have the intelligence to track the impacted transactions and business processes capable of validating them for correctness.

Syndicated loans is another example where product analysis is mandatory to enhance core banking systems. More than one financial institution gets into a syndication, one of them acts as a lead, and the rest as participants. The interest paid by the end borrower (considering US end client) is split between the participants. How does the lead decide on which participant should FATCA-withhold be applied to? In what circumstances does FATCA come into picture?

These questions can be answered with effective product analysis and application of FATCA rules. Once decided, the IT and core banking systems should be enhanced to cater to these needs. A capable consulting partner can reduce the complexity of these decisions and a good technology partner can assist in solution implementation.

To ensure successful regulatory compliance including FATCA, client onboarding or KYC re-engineering and due diligence, please feel free to email us at info@mindtree.com.

About the author

Bharath Bhaskar is a Senior Consultant with Banking and Financial Services. He is a leader in the Governance, Risk and Compliance vertical. He has spent over 12 years with leading financial organizations assisting in mergers, acquisitions, legacy modernization and regulatory and compliance matters. He has successfully managed a range of cross-functional projects operating in various geographies. His is currently assisting financial institutions with governmental regulatory compliance needs and resolution and mitigation of their impact on business processes and IT systems.

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