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Regulatory Practice Letter

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Enhanced Prudential Standards and Early Remediation Requirements – Fed Proposed Rule

Executive Summary

The Federal Reserve Board ("Fed") released a proposed rule on December 20, 2011 that would create a new Regulation YY, *Enhanced Prudential Standards*, to implement portions of Sections 165 and 166 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") for U.S. bank holding companies ("BHCs") with total consolidated assets of $50 billion or more ("Large BHCs") and nonbank financial companies deemed systemically important by the Financial Stability Oversight Council ("Council") and supervised by the Fed ("covered nonbank companies" and collectively with Large BHCs "covered companies").

In particular, the proposed rule would implement the Section 165 requirements related to: risk-based capital and leverage; liquidity; single-counterparty credit limits; overall risk management; and risk committees; and stress tests. A debt-to-equity limit would also be imposed for covered nonbank companies that the Council has determined pose a grave threat to financial stability of the U.S. The proposed rule would also implement the requirements of Section 166 related to establishing measures of financial condition and related remediation requirements that increase in stringency as the financial condition of a covered company declines.

The proposed rule does not cover foreign banking organizations with U.S. banking operations (a U.S. branch, a U.S. agency, or a U.S. subsidiary BHC or bank) and total global consolidated assets of $50 billion or more though they are covered by Sections 165 and 166 of the Dodd-Frank Act. The Fed intends to release a separate proposal for applying the proposed enhanced prudential standards under Regulation YY to these entities. Similarly, the proposed rules are not generally applicable to savings and loan holding companies ("SLHCs") except for the annual stress test requirement, which would apply to SLHCs with total assets of more than $10 billion once the Fed has established risk-based capital standards for SLHCs. Again, the Fed expects to release a separate proposed rule that would apply the enhanced standards to SLHCs with total consolidated assets of $50 billion or more and "substantial banking activities."

Comments are requested no later than March 31, 2012. As proposed, a company that is a covered company on the effective date of the final rule would generally be subject to the enhanced prudential standards beginning on the first day of the fifth quarter following the effective date. However, compliance with the stress testing requirements would begin as of the effective date.

Background

The proposed rule closely follows many of the requirements established in Sections 165 and 166 of the Dodd-Frank Act. In October 2011, the Fed issued a joint final rule with the Federal Deposit Insurance Corporation ("FDIC") to implement Section 165(d), which requires each covered company to submit periodically to the Fed and the FDIC a plan for rapid and orderly resolution under the Bankruptcy Code in the event of its material financial distress or failure. (Please refer to Regulatory Practice Letter 11-22 for a detailed outline of the final rule.) The agencies expect to implement periodic reporting of credit exposures, as also required by the rule, at a later date.

In November 2011, the Fed released a final rule that requires Large BHCs to submit an annual capital plan to the Fed for review and to request prior approval in certain circumstances before making a capital distribution ("Capital Plan Rule"). Please refer to Regulatory Practice Letter 12-03 for a detailed outline of the final rule.) The Fed expects that Large BHCs will reflect the enhanced prudential standards, including stress test results, in their capital planning strategies and internal capital adequacy processes that culminate in the preparation of their capital plan.

In addition to required standards, the Dodd-Frank Act authorizes but does not require the Fed to establish additional enhanced standards for covered companies relating to: contingent capital; public disclosures; short-term debt limits; and such other prudential standards as the Fed determines appropriate. The Fed is not proposing any of these supplemental standards with this rule but states that it continues to consider whether adopting any of these standards would be appropriate.

Description

Scope

The proposed rule would establish enhanced prudential standards for covered companies in the following areas:

- Capital and leverage;
- Liquidity;
- Single-counterparty credit limits;
- Risk management and risk committees;
- Stress testing;
- Debt-to-equity limits (for covered nonbank companies); and
- Early remediation.

Some of the standards would also apply to certain BHCs and state member banks with total consolidated assets of more than $10 billion. These are noted below.

As currently proposed, the enhanced prudential standards would apply to:

- U.S. BHCs with total consolidated assets of $50 billion or more, measured as the average of the four most recent quarterly reports to the Fed (effective on the due date of the FR-Y9C).
  - ➢ A covered company would remain a covered company until its total consolidated assets fall and remain below $50 billion for four consecutive quarters.
  - ➢ U.S. BHC subsidiaries of foreign banking organizations that rely on Supervision and Regulation Letter 01-01 and alone meet the asset threshold

  - would not be subject to the rule until July 21, 2015, except for the liquidity, risk management and debt-to-equity limit provisions.
- Publicly traded U.S. BHCs with total consolidated assets of more than $10 billion for purposes of the risk committee requirements, where assets are measured as the average of the four most recent quarterly reports to the Fed.
- U.S. BHCs, SLHCs and state member banks with total consolidated assets of more than $10 billion for purposes of the annual stress test requirement only.
  - Application to SLHCs would be delayed until the Fed establishes risk-based capital requirements for SLHCs.
- Nonbank financial companies designated as systemically important by the Council and subject to supervision by the Fed.

Sections 165 and 166 of the Dodd-Frank Act also apply to foreign banking organizations that have U.S. banking operations (a U.S. branch, a U.S. agency, or a U.S. subsidiary BHC or bank) and total global consolidated assets of $50 billion or more. The Fed intends to release a separate proposal for applying the proposed enhanced prudential standards under Regulation YY to these entities.

Similarly, the Fed intends to issue a separate proposal to initially apply the enhanced standards and early remediation requirements to all SLHCs with total consolidated assets of $50 billion or more and a) savings association subsidiaries which comprise 25 percent or more of such SLHC's total consolidated assets, or b) control one or more savings associations with total consolidated assets of $50 billion or more. These standards would be applied to SLHCs after the Fed establishes risk-based capital requirements for SLHCs.

Companies covered by the rule would be subject to its requirements beginning on the first day of the fifth quarter following the date on which they become a covered company.

Risk-Based Capital and Leverage Standards

For Covered BHCs

The proposed enhanced prudential standards for risk-based capital and leverage requirements would be implemented in two phases:

- Under the first phase, covered BHC companies would be required to comply with the Fed's Capital Plan Rule, which requires the annual submission of a capital plan that includes both supervisory and company-run stress tests pursuant to Section 165 (see discussion below).
  - An acceptable capital plan must demonstrate the covered company's ability to maintain capital above existing minimum regulatory capital ratios (i.e., a tier 1 risk based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent, as calculated according to the general risk-based capital rules, and a tier 1 leverage ratio of 4 percent as calculated under the leverage rule) and above a tier 1 common ratio of 5 percent under both expected and stressed conditions over a minimum nine-quarter planning horizon.
  - An unsatisfactory capital plan will result in limitations on capital distributions.
- For the second phase, the Fed intends to propose a quantitative risk-based capital surcharge for some or all of the covered BHCs that would be based on the Basel Committee on Banking Supervision's ("Basel Committee") approach for global systemically important banks (100 to 350 basis points surcharge) and is

consistent with the Basel Committee's implementation timeframe (i.e., to be adopted in 2014 with implementation of the capital surcharge to be phased-in between 2016 and 2019).

For Nonbank Covered Companies

A nonbank covered company would be required to:

- Report its risk-based capital and leverage ratios quarterly to the Fed.
- Calculate its minimum risk-based and leverage capital requirements as if it were a BHC in accordance with any minimum capital requirements established by the Fed for BHCs, including the general risk-based capital rule, leverage rule, market risk rule and the advanced approaches risk-based capital rule;
- Hold capital sufficient to meet a tier 1 risk based capital ratio of 4 percent and a total risk-based capital ratio of 8 percent, as calculated according to the general risk-based capital rules, and a tier 1 leverage ratio of 4 percent as calculated under the leverage rule; and
- Comply with, and hold capital commensurate with, the requirements of any regulations adopted by the Fed relating to capital plans and stress tests as if the covered company were a BHC.

Liquidity

The prorposed rule defines liquidity as "a covered company's capacity to efficiently meet its expected and unexpected cash flows and collateral needs at a reasonable cost without adversely affecting the daily operations or the financial condition of the covered company." Like the capital and leverage standards, the Fed proposes to implement the enhanced prudential liquidity standards in two phases.

The first phase would establish a list of requirements as outlined in the proposed rule that are based on the Fed's Supervision and Regulation Letter 10-06, *Interagency Policy Statement on Funding and Liquidity Risk Management*. Covered companies would be required to take a number of steps to manage liquidity risk, including meet specified corporate governance requirements around liquidity risk management, project cash flow needs over various time horizons, establish internal limits on certain liquidity metrics, and maintain a contingency funding plan that identifies potential sources of liquidity strain and alternative sources of funding when usual sources of liquidity are unavailable. More specifically:

- The board of directors or the risk committee would be required to oversee the liquidity risk management processes, and review and approve the liquidity risk management strategies, policies and procedures established, and carried out, by senior management. The board must establish the liquidity risk tolerance at least annually.
- Senior management would be required to establish and implement strategies, policies, and procedures for managing liquidity risk, including overseeing the development and implementation of liquidity risk measurement and reporting systems, cash flow projections, liquidity stress testing, liquidity buffer, contingency funding plan, specific limits, and monitoring procedures.
- A review function that is "independent of the management functions that execute funding," would be required to be in place to review the adequacy and effectiveness of the liquidity risk management processes at least annually.
- Short-term cash flow projections would be required daily and long-term cash flows would be required to be updated at least monthly. The cash flows would

be required to be comprehensive and provide sufficient detail to reflect the covered company's capital structure, risk profile, complexity, activities, size, and other appropriate risk related factors.

- The cash flow projections would be required to be subject to regular stress testing at least monthly. The results of the stress testing would be used to determine the size of the liquidity buffer and to contribute to the quantitative component of the contingency funding plan.
  - Stress testing must incorporate a range of stress scenarios that may significantly impact the covered company's liquidity, taking into consideration the covered company's balance sheet exposures, off-balance sheet exposures, business lines, organizational structure, and other characteristics. At a minimum, stress testing must incorporate separate stress scenarios to account for market stress, idiosyncratic stress, and combined market and idiosyncratic stresses.
  - Stress testing would be required at least monthly to measure liquidity needs at 30-day, 90-day and one-year intervals during times of instability in the financial markets.
- A liquidity buffer, composed of highly liquid assets, would be required to be sufficient to cover 30-day stressed net cash outflows under the internal stress scenarios.
- A contingency funding plan, commensurate with the covered company's capital structure, risk profile, complexity, activities, size, other risk related factors and it liquidity risk tolerance would be required to be maintained and to be updated at least annually. The plan would be required to include four components: quantitative assessment; event management, monitoring, and testing.
- Specific limits would be required for: 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 exposures and other exposures that could create funding needs during liquidity stress events.
- Monitoring procedures would be required for: assets pledged as collateral or available to be pledged; liquidity funding exposures and needs within and across significant legal entities, currencies and business lines; and intraday liquidity risk exposure.

In the second implementation phase, the Fed anticipates requiring covered companies to satisfy specific quantitative liquidity requirements that are derived from or consistent with the Basel III liquidity rules, which introduce two new measures:

- A Liquidity Coverage Ratio ("LCR"), which would require banks to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows over a 30-day time horizon under a supervisory stress scenario. Compliance with the LCR is required by 2015.
- A Net Stable Funding Ratio ("NSFR"), which would require banks to enhance their liquidity risk resiliency out to one year. Compliance with the NSFR is required by 2018.

Single-Counterparty Credit Limits

- In general, a covered company, together with its subsidiaries, would not be permitted to have an aggregate net credit exposure to any unaffiliated counterparty that exceeds 25 percent of the consolidated capital stock and surplus of the covered company.

  - The Fed may adjust this threshold if necessary to mitigate risks to the financial stability of the U.S.
  - Credit exposures are defined in Section 165 to include all extensions of credit to the company, including loans, deposits, and lines of credit; all repurchase agreements, reverse repurchase agreements, securities borrowing and lending transactions with the company (to the extent that such transactions create credit exposure for the covered company); all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company; all purchases of or investments in securities issued by the company; counterparty credit exposure to the company in connection with a derivative transaction between the covered company and the company; and any other similar transaction that the Fed, by regulation, determines to be a credit exposure for purposes of section 165.
  - "Capital stock and surplus" would be defined as total regulatory capital plus excess loan loss reserves.
- A "major covered company," defined as a BHC or nonbank covered company with total consolidated assets of $500 billion or more, would not be permitted to have, together with its subsidiaries, an aggregate net credit exposure to any unaffiliated counterparty that is also a major covered counterparty that exceeds 10 percent of the consolidated capital stock and surplus of the major covered company.
- The single counterparty credit limit requirement is separate and independent from the investment securities limits and lending limits of the *National Bank Act*.
- Compliance would be required on a daily basis at the close of each business day.
- The following categories of credit transactions are exempt from the limits on credit exposure:
  - Claims that are directly and fully guaranteed as to principal and interest by the U.S. governments or its agencies.
  - Claims that are directly and fully guaranteed as to principal and interest by the Fannie Mae or Freddie Mac while under conservatorship.
  - Intraday exposure to a counterparty.

Risk Management

To address risk management, the proposed rule would require each covered company and each publicly-traded BHC with more than $10 billion in total consolidated assets that is not a covered company to:

- Maintain an enterprise-wide risk committee that.
  - Is comprised of board members;
  - Is chaired by an independent board member;
  - Has at least one member of the risk committee with risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities, size, and other risk related factors.

Covered companies would be required to meet enhanced risk management standards including requirements for:

- Operating the risk committee, including reporting directly to the board and not being part of another committee or a joint committee.
- Employing a chief risk officer that reports directly to the risk committee and the chief executive officer and has risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities, size, and other risk related factors.

Stress Testing

The Fed states the stress testing requirements are designed to work in tandem with the Capital Plan Rule. The results of the tests would be used to make appropriate changes to the covered company's: capital structure (including the level and composition of capital); exposures, concentrations, and risk positions; and any plans for recovery and resolution;

Supervisory Stress-Tests

On an annual basis, the Fed proposes to conduct an analysis of the capital of each covered company to evaluate its ability to absorb losses in adverse economic and financial conditions. Covered companies would be required to submit consolidated data, as determined by the Fed, to make pro forma estimates over a period of at least 9 calendar quarters under baseline, adverse and severely adverse conditions and other scenarios determined appropriate by the Fed. The data collected is expected to coordinate with the data collection required for the Capital Plan Rule, and as outlined in the supplemental information of the release would be based on data as of September 30 plus other required information.

The Fed also proposes to publish company-specific data based on the annual stress test results. The report is expected to include estimated losses, pre-provision net revenues, allowance for loan losses, and pro-forma regulatory capital and other ratios, for each company for each quarter over the planning horizon.

Company-Run Stress Tests

The company-run stress test requirement would apply to covered companies (BHCs, and nonbank companies) and BHCs and state member banks with more than $10 billion in total consolidated assets that are not a covered company. In general, the entities would be required to complete an annual stress test as of September 30 of each calendar year, except for the trading and counterparty exposures data for which the Fed would provide the appropriate "as of" date.

- Scenarios would be provided by the Fed and reflect economic and financial conditions under a baseline, adverse and severely adverse scenario.
- Results would be reported to the Fed no later than January 5. Covered companies would be permitted to refer to information submitted in connection with their capital plan.
- The covered company or BHC that is not a covered company would be required to publish a summary of the results within 90 days of submission including, a description of the types of risks tested, a general description of the methodologies employed, and aggregate losses, pre-provision net revenue, allowance for loan losses, net income, and pro forma capital levels and capital ratios over the planning horizon under each scenario.

Covered companies (covered BHCs and covered nonbank companies) would be required to complete an additional stress test as of March 30 of each year, except for the trading and counterparty exposures data for which the Fed would provide the appropriate "as of" date.

- Scenarios would be developed by the covered companies to reflect a minimum of three economic and financial conditions under a baseline, adverse and severely adverse scenario.
- Results would be reported to the Fed no later than July 5.

- The covered company would be required to publish a summary of the results within 90 days of submission.

Debt-to-Equity Limits for Covered Nonbank Companies

The proposed rule would establish procedures to notify a covered nonbank company that it must comply with a 15-to-1 debt-to-equity ratio after a determination by the Council that the company poses a grave threat to the financial stability of the U.S. and that the imposition of the requirement is necessary to mitigate the risk. In particular:

- A covered nonbank company would be required to comply with the 15-to-1 debt-to-equity ratio within 180 days of receiving notice from the Council.
- The Fed may extend the period for compliance for up to two additional 90-day periods if the Fed determines the company has made a good faith effort to comply and the extension would be in the public interest.
- Debt-to-equity would be calculated as the ratio of total liabilities to total equity capital minus goodwill.

The requirement would terminate once the Council determines the covered nonbank company no longer poses a grave threat to the financial stability of the U.S. and the requirement is no longer necessary.

Early Remediation

The proposed rule would establish a regime for the early remediation of financial distress at covered companies that includes four levels of remediation requirements and several forward-looking triggers designed to identify emerging or potential issues before they develop into larger problems.

The four levels of remediation are:

- Level 1 - Heightened supervisory review - in which the Fed would conduct a targeted review of the covered company to determine if it should be moved to the next level of remediation;
- Level 2 - Initial remediation - in which a covered company would be subject to restrictions on growth and capital distributions;
- Level 3 – Recovery - in which a firm would be subject to a prohibition on growth and capital distributions, limits on executive compensation, and requirements to raise additional capital, and additional requirements on a case-by-case basis; and
- Level 4 - Recommended resolution - in which the Fed would consider whether to recommend to the Treasury Department and the Federal Deposit Insurance Corporation that the firm be resolved under the orderly liquidation authority provided for in Title II of the Dodd-Frank Act.

Proposed trigger events would be applicable at each remediation level for:

- Capital and leverage ratio levels;
- Capital ratios calculated under the stress test scenarios;
- Risk management and risk committee weaknesses;
- Liquidity risk deficiencies; and
- Market indicator thresholds and breach periods as identified by the Fed.

Commentary

The implementation of sections 165 and 166 of the Dodd-Frank Act address shortcomings that were observed during the economic crisis that began in 2008. At that point in time, there was limited information available to regulators on counterparty exposures and interconnectivities between firms that could threaten the broader market.

The provisions outlined in the proposed rule would further increase transparency from an enterprise risk management and capital adequacy viewpoint and empower the regulatory agencies with increased supervisory authorities. The proposed liquidity ratios can help identify potential liquidity concerns during a period of economic turmoil and are consistent with Basel requirements; the stress testing procedures would provide an additional layer of oversight and protection against unanticipated outflows in an unstable environment.

The proposed rule also identifies which institutions may be subject to this rule. The requirements are not exclusive to banks and are also not rigid in terms of minimum asset size. The primary factor in determining applicability is the correlation between the institution and the market as a whole. In some cases companies may want to reassess, and possibly reduce, their systemic footprint where consistent with their strategic objectives to lessen regulatory oversight.

As the shift in regulatory focus becomes more centered in systematic risk and the interconnectivity amongst institutions to achieve macroprudential supervision initiatives, bank management should be cognizant of the implications arising from this proposed rule and should consider the need for possible changes and enhancement to existing governance, risk management, liquidity and other oversight monitoring practices.

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