KPMG

Client Alert

Americas FS Regulatory Center of Excellence

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Supervision of Large Financial Institutions

The Federal Reserve proposes a new supervisory ratings system for large financial institutions and announces additional forthcoming guidance

The Federal Reserve Board (Federal Reserve) has proposed a new ratings system for large financial institutions (LFIs) that it intends to begin using in 2018.

The proposed LFI ratings system is intended to "fully align" with the Federal Reserve's current supervisory programs and practices, which are based on the core objectives of its LFI supervisory framework—reducing the probability of an LFI failing or experiencing material distress and reducing the risk to U.S. financial stability. The new system is also intended to enhance the clarity and consistency of communications regarding supervisory assessments as well as the consequences of a given rating.

For purposes of the new ratings system, LFIs would be defined to include: bank holding companies (BHCs) with total consolidated assets of $50 billion or more; noninsurance, noncommercial savings and loan holding companies (SLHCs) with total consolidated assets of $50 billion or more; and U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs). Systemically important nonbank financial companies (SIFIs) designated by the Financial Stability Oversight Council for supervision by the Federal Reserve may be added to the scope at a later date.

For LFIs covered by the new ratings system, the Federal Reserve would evaluate and assign individual ratings for each of three components: capital planning and positions; liquidity risk management and positions; and governance and controls. Assigned ratings would be based on multiple factors, including an assessment of the individual firm's positions and practices as well as findings from coordinated examinations conducted across several firms, commonly referred to as "horizontal examinations." To more clearly communicate supervisory assessments and associated consequences for each of the three components, no standalone composite rating would be assigned. A fourth ratings component covering resolution planning efforts by LISCC (Large Institutions Supervision Coordinating Committee) firms and other "select LFIs" is being considered for addition at a later time.

LFI components

1. Capital planning and positions

   — Assessments would consider i) the effectiveness of the governance and planning processes a firm uses to determine the necessary amounts of capital to cover its risks and exposures and to support activities through a range of conditions; and ii) the sufficiency of a firm's capital positions to comply with regulatory requirements and support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

- Component ratings would be based in large part on findings from CCAR (Comprehensive Capital Analysis and Review) for relevant LFIs (consistent with Supervision and Regulation (SR) Letter 15-18, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms") and "similar supervisory activities" for other LFIs (consistent with SR Letter 15-19, "Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms").

2. Liquidity risk management and positions

- Assessments would consider i) the effectiveness of the governance and risk management processes a firm uses to determine necessary levels of liquidity to cover its risks and exposures and to support activities through a range of conditions; and ii) the sufficiency of a firm's liquidity positions to comply with regulatory requirements and support the firm's ongoing obligations through a range of conditions.
- Component ratings would be based on i) ongoing assessments of a firm's liquidity positions and risk management practices conducted through supervision, and ii) findings from horizontal examinations, including CLAR (Comprehensive Liquidity Analysis and Review) and similar horizontal and/or targeted examinations.

3. Governance and controls

This rating would assess a firm's effectiveness in aligning strategic business objectives with a firm's risk tolerance and risk management capabilities; maintaining strong, effective, and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

- Assessments would consider the effectiveness of a firm's i) board of directors (board),including board committees as appropriate ii) management of core business lines and independent risk management and controls, and iii) recovery planning (at present, for domestic LISCC firms only).
- Component ratings would be based on ongoing firm-specific and horizontal examinations.

Concurrent with the release of the proposed LFI rating system, the Federal Reserve also released proposed corporate governance guidance addressing the effectiveness of boards. The Federal Reserve intends to use this guidance as part of its evaluation processes for the governance and controls component rating. (KPMG's Client Alert on the proposed guidance for boards is available here.) The Federal Reserve also expects to release a proposal on supervisory expectations relating to the management of core business lines and independent risk management and controls in the near term. (Please refer to the separate discussion below.)

LFI ratings scale

One of four ratings would be assigned to a component based on the following scale:

- Satisfactory – The firm is considered safe and sound and broadly meets supervisory expectations.
- Satisfactory Watch – The firm is generally considered safe and sound, but there are issues that are sufficiently material that, if not resolved in a timely manner in the normal course of business (generally no longer than 18 months), would put the safety and soundness of the firm at risk.
- Deficient-1 – Financial and/or operational deficiencies put the safety and soundness of the firm at risk through a range of conditions.
- Deficient-2 - Financial and/or operational deficiencies materially threaten the firm's safety and soundness.

During the initial supervisory cycle of the LFI ratings system (during 2018), each firm would receive all three component ratings concurrently. Thereafter individual components ratings would be assigned and communicated on a rolling basis, though at least annually.

Consequences

Firms that receive a "Satisfactory" or "Satisfactory Watch" in each of the three component ratings would be considered "well managed."

A "Deficient–1" rating in any component would generally result in a firm being prohibited from engaging in new or expansionary activities unless it can sufficiently demonstrate certain requirements to the Federal Reserve. Further the "Deficient-1" rating would generally indicate a firm should be subject to either an informal or formal enforcement action, which could similarly be a barrier to receiving approval for new or expansionary activity.

A "Deficient-2" rating in any component would generally result in a formal enforcement action and the firm deemed to be in "troubled condition," rendering a firm unlikely to receive approval for any new or expansionary activities and also subject to restrictions or higher charges when accessing the Federal Reserve's discount window or in gaining access to intraday credit.

Forthcoming proposals

As part of the LFI rating system release, the Federal Reserve has outlined forthcoming proposed guidance that it would use to evaluate the "management of core business lines and independent risk management and controls" portion of the governance and controls component. Three sets of expectations are broadly outlined:

- Expectations for senior management that include managing day-to-day operations; implementing the strategy and risk tolerance approved by the board; maintaining the risk management and internal controls frameworks; keeping apprised of current and emerging risk; and having a succession and contingency staffing plans for key positions and compensation and performance management programs that promote and enforce prudent risk-taking and business practices.
- Expectations for the management of core business lines (CBLs), including consideration of current and emerging risks, risk limits, resources and infrastructure, internal controls, and accountability. For LISCC firms, all business lines would be considered CBLs. For other LFI firms, CBLs would be defined to as business lines where a significant control disruption, failure, or loss event would result in material loss of revenue, profit, or franchise value or resulting in significant consumer harm.
- Expectations for independent risk management and controls including the roles and responsibilities of the chief risk officer and chief audit executive, setting risk tolerances and limits, testing and monitoring of internal controls, and the roles and responsibilities of internal audit.

Moving forward

Comments are due to the Federal Reserve no later than October 16, 2017

The Federal Reserve notes that it intends the new LFI ratings system to align with its LFI supervision framework as described in SR Letter 12-17, "Consolidated Supervision Framework for Large Financial Institutions," and supported by enhanced regulatory requirements, supervisory expectations and practices established over recent years to strengthen the ability of large systemically important firms to sustain operations through a range of stressful conditions and events. The agency perceives the introduction of the new rating system to be a "natural next step" in the build-out of this framework and expects the transition from the current RFI/C(D) rating system, which has been used for all BHCs regardless of asset size, complexity, or systemic importance since before the 2007/2008 financial crisis, to be "routine in most respects."

Financial services companies, however, should anticipate that they may be operating within an evolving framework reflecting the Federal Reserve's newly proposed guidance on board effectiveness and forthcoming guidance managing core business lines and independent risk management and controls (both of which will be used to assess corporate governance and controls), along with intended updates to SR Letter 12-17 once the ratings system is finalized.

Notably, large FBOs are covered by the LFI ratings system proposal but are not included in the recently released corporate governance guidance for boards, which will be used to evaluate part of the Governance and Controls component in the LFI ratings system. The Federal Reserve expects to propose guidance for IHC boards at a later date.

Financial services companies should also note that the LFI ratings system is one of many changes the Federal Reserve is working on, which, in total, will impact financial services companies of all sizes and touch on operations, compliance, risk management, and accountability. As SR Letters are revised and reissued, they will set new supervisory expectations in areas that will ultimately be factored into a firm's supervisory ratings and firms must be aware of and prepared to implement any changes within their operations and practices consistent with the guidance.

We would welcome discussion on these emerging developments and encourage you to contact us with any questions you might have.

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