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Federal Reserve Board Toughens Oversight of SIFIs: Enhanced Prudential Standards

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Background

Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") to deal with the myriad problems that it believed caused the 2008 financial crisis. Among the problems the legislation sought to address was the macro issue of what to do about the "Too Big To Fail" larger financial services organizations and the impact their financial distress might have upon the stability of the United States banking or financial system. One of the lessons learned that the Congress tried to address is to get ahead of the financial distress issue and try to minimize any negative fallout onto the US economy. One approach the Congress chose is found in sections 165 and 166 of Dodd-Frank. That is, by granting the Federal Reserve Board ("Board") the authority to put in place on its own, or following recommendations by the Financial Stability Oversight Council ("Council"), in addition to what is in place for the financial services industry at large - stronger, stricter and enhanced prudential standards for the larger nonbank financial companies and for those bank holding companies with total consolidated assets of $50 billion or more.

In effect, if a bank holding company or a nonbank financial services company is designated by the Council as a Systemically Important Financial Institution, that is a SIFI or "covered company," it will become subject to regulatory standards that are more demanding than those standards imposed on their non-SIFI competitors. These more exacting standards, were put out for comment by the Board December 23, 2011, as a proposed rule ("Proposed Rule"). The Proposed Rule focuses on seven areas:

- Risk-Based Capital and Leverage Requirements
- Liquidity Requirements
- Single-Counterparty Credit Limits
- Risk Management Requirements
- Stress Testing Requirements
- Debt-to-Equity Limits
- Early Remediation Framework

The Board notes that key components of these proposed Enhanced Prudential Standards have been under development by the Basel Committee on Banking Supervision ("BCBS"), particularly with respect to the Basel III capital rules and the capital surcharge for SIFIs. The same Basel Committee has proposed liquidity rules that also need to be considered by the Board. Both

of these enhanced prudential approaches will be taken up by the Board and implemented on a phased basis. Public comments on the proposed rules will be taken by the Board until March 31, 2012.

Foreign Bank Holding Companies

The enhanced prudential standards as proposed are not intended to apply to foreign banking organizations. The Board will issue a separate proposal shortly that would apply the enhanced standards of sections 165 and 166 to these banking organizations. However, a "covered company," as proposed would include a foreign banking organization's US based bank holding company subsidiary that on its own has total consolidated assets of $50 billion or more (See Federal Reserve Form FR Y 7Q). This proposal does not reach the US operations of a foreign banking organization that are conducted outside its US based bank holding company subsidiary. In applying its enhanced standards to foreign financial companies, the Board must give due regard to the principle of national treatment and equality of competitive opportunity, and consider the extent to which the foreign company is subject to consolidated home country supervision standards that are comparable to consolidated US standards.

Supplemental Standards

Section 165 authorizes but does not require the Board to establish additional enhanced standards for the covered companies. These additional standards include: (i) contingent capital requirements, (ii) enhanced public disclosures, (iii) short-term debt limits, and (iv) such other prudential standards the Board determines are appropriate. The Board is not proposing any of these supplemental standards at this time.

Board Has Discretion in Applying Enhanced Standards

In prescribing prudential standards for SIFIs or covered companies, the Board may take into account differences among bank holding companies and nonbank financial companies, based on an array of considerations (found at Dodd Frank sections 113(a) and (b)) and any other risk related factors the Board deems appropriate.

- The Board can also tailor the application of the standards, including differentiating among covered companies on an individual basis or by category.
- When differentiating among companies the Board may consider the companies' size, capital structure, riskiness, complexity, financial activities, and whatever other risk factor the Board deems appropriate.
- The Board is required to consult with each Council member who is the primary supervisor of the relevant company.
- The Board, following a Council recommendation, can raise the $50 billion asset threshold.

Reservation of Authority

The Board can subject **any** bank holding company that is not a covered company to one or more of the enhanced prudential standards if the Board determines that is necessary or appropriate to protect the safety and soundness of the company, or to promote financial stability. In making that determination, the Board will consider the company's capital structure, size, complexity, risk profile, scope of operations, or financial condition, and any other risk-related factors the Board deems appropriate.

Savings and Loan Holding Companies

Under Dodd-Frank the Board is now the primary federal financial regulatory agency for savings and loan holding companies. The Board will issue a separate proposal for notice and comment to initially apply the enhanced standards and early remediation requirements to all savings and loan holding companies with total consolidated assets of $50 billion or more. It has the authority to push those requirements down to any savings and loan holding company to ensure their safety and soundness.

The following discussion addresses each of the proposed enhanced standards. The memorandum also outlines some of the potential implications and consequences if the rules were to be adopted as proposed.

Risk-Based Capital and Leverage Requirements

The proposed capital and leverage requirements will be implemented in two phases. The first phase will follow the Board's capital plan rule, which was issued November 22, 2011. The second phase will be the Board issuing a proposal to implement the BCBS' risk based capital surcharge for the largest financial services players.

Covered Bank Holding Companies

Covered bank holding companies must comply with the capital plans and stress test requirements the Board adopted November 22, 2011. In effect, these companies must submit their board of directors' approved annual capital plans to the Board demonstrating their ability to maintain capital above the Board's minimum risk based capital ratios (total capital of 8 percent, tier 1 capital ratio and tier 1 leverage ratio of 4 percent) under both baseline and stressed conditions defined by the Board over a minimum nine quarter forward looking planning horizon. Their tier 1 capital ratio must include at a minimum a common risk based capital ratio of 5 percent.

- Their capital plans must include a discussion of the bank holding company's sources and uses of capital reflecting the risk profile of the firm over the planning horizon.
- The stressed scenarios must include any scenarios provided by the Board as well as at least one developed by the bank holding company appropriate to its business model.

- The bank holding company must provide a detailed description of its process for assessing capital adequacy, as well as how it will operate and meet its obligations under stressful conditions. If this becomes a problem, the company generally may not make any capital distributions until it receives Board approval of its capital plan.

Nonbank Covered Companies

A nonbank covered company becomes subject to the capital plan rule as though it was a bank holding company in the calendar year it is designated a SIFI by the Council. In 180 days following its designation by the Council, it becomes subject to the minimum risk based capital and leverage requirements: (i) tier 1 risk based capital ratio of 4 percent, (ii) total risk based capital ratio of 8 percent, and (iii) tier 1 leverage ratio of 4 percent.

- The nonbank covered company must report quarterly to the Board its risk based capital and leverage ratios. If it fails to meet the required minimums, the Board must be notified immediately.
- The Board has the authority to require the nonbank company to hold more capital or be subject to restrictions or requirements if the Board determines that is necessary to mitigate the risk to US financial stability if the covered company were to fail or encounter material financial distress.

Basel III's Quantitative Risk-Based Capital Surcharge

In November 2011 the BCBS agreed to require the Global-SIBS (Systemically Important Banks) to hold an additional amount of common equity above the regulatory minimums. The BCBS framework would establish five capital surcharge categories ranging from 100 to 350 basis points based on a 12 factor formula. The formula includes measures of size, interconnectedness, complexity, lack of substitutes and cross-border activity. Assuming the Board supplements the enhanced capital charge with the Basel III surcharge, the surcharge would be phased in equal increments from 2016 to 2019, in parallel with Basel III's capital conservation buffer.

Implications

- The enhanced capital requirements may tilt the playing field even more toward SIFIs, if customers and investors are in search of safety. At the same time, investors as a source of capital may seek out alternative investments since historical returns on capital for SIFIs are likely to decline.
- An important question is whether SIFIs will be able to attract sufficient capital to meet regulatory requirements.
- Board has expansive discretionary authority to "push down" enhanced prudential standards beyond the SIFIs.

Liquidity Requirements

- The Proposed Rule defines "liquidity" as "the 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." It defines "liquidity risk" as "the risk that a covered company's financial condition or safety and soundness will be adversely affected by its inability or perceived inability to meet its cash and collateral obligations."
- Many solvent firms experienced significant financial stress during the crisis because of lapses in their liquidity risk management practices. The Proposed Rule contains a number of new requirements specifically designed to improve such practices. This section discusses the liquidity risk management standards contained in the Proposed Rule. These requirements will be phased in, first in the United States and subsequently globally.

Basel III Liquidity Requirements

The proposed Dodd-Frank liquidity standards are part of an overall new regulatory liquidity regime. The complete liquidity framework will incorporate the Dodd-Frank liquidity risk management requirements as well as the Basel III quantitative liquidity standards. The Basel III requirements are to be put into effect following the implementation of the Dodd-Frank rules.

The core components of the proposed Basel III standards are two new liquidity metrics, the Liquidity Coverage Ratio ("LCR") and the Net Stable Funding Ratio ("NSFR"). The LCR requires 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. The NSFR requires banks to enhance their liquidity resiliency out to one year. Essentially, banks will have to be able to demonstrate that they have access to stable funding, such as customer deposits and long term wholesale instruments, to cover their funding requirements for this period. Both proposals are currently being reviewed by domestic and international regulatory bodies to assess their impact on financial markets and institutions. The target implementation date for the LCR is 2015 and 2018 for the NSFR.

Proposed New Corporate Governance Requirements

The Proposed Rule requires that a covered company's board of directors (or its risk committee) must oversee the company's risk management processes, and must review and approve the liquidity risk management strategies, policies and procedures adopted by senior management. The Proposed Rule imposes specific requirements on a company's board of directors.

- The board must establish the liquidity risk tolerance of the covered company on an annual basis. The risk tolerance is the acceptable level of risk the covered company may assume in connection with its business strategies.

- The risk committee must review and approve the liquidity costs, benefits and risks of each significant new business line or product before the covered firm may engage in the new business line or introduce the new product. This review should ensure that the liquidity risks associated with the new business or product fit within the liquidity risk tolerance established by the board.
- The board must review and approve the firm's contingency funding plan on an annual basis.
- The risk committee must conduct reviews of the firm's cash flow projections, its liquidity stress testing methodologies and procedures, as well as the stress test results, among other things, and approve the size and composition of the liquidity buffer.
- Senior management must establish and implement liquidity risk management strategies, policies and procedures, including the development of monitoring and reporting systems, cash flow projections, stress tests, and liquidity buffers.
- Covered firms must establish an independent review process to annually evaluate the adequacy and effectiveness of their liquidity risk management processes (including compliance with all applicable laws and regulations), and report all findings to the board.

In addition to the Basel III and new corporate governance requirements, the enhanced prudential standards impose further action steps on SIFIs, which are outlined below.

Cash Flow Projections

Covered firms must produce dynamic and comprehensive cash flow projections over various time periods and identify and quantify specific cash flow mismatches. These projections must provide sufficient detail to reflect the capital structure, activities, risk profile, and size, among other items, of the covered firm. The Proposed Rule allows management to make informed assumptions regarding the future behavior of assets and liabilities.

Stress Tests

Covered companies must regularly conduct stress tests of their cash flow projections and assess the effects on the firm's liquidity. These stress tests have to cover the full set of activities, exposures, risks, both on and off-balance sheet, and must include a range of historically based and hypothetical scenarios (including extreme events). The stress scenarios must be forward looking and must include changes to the company's exposures as well as changes in the broader economic and financial environment.

The stress tests have to cover a minimum of four specified time horizons including overnight, 30 day, 90 day, and one year periods. The test designs must also include certain features to support the establishment of liquidity buffers. Firms are required to conduct tests on a monthly basis but must also be capable of conducting more frequent tests. Finally, covered firms must

establish and maintain policies and procedures regarding testing practices, methodologies and assumptions, as well as the management and systems necessary to maintain a testing program.

Liquidity Buffers

The Proposed Rule requires firms to maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected outflows, or loss or impairment of funding sources for 30 days over a range of liquidity stress scenarios. Only assets that can be quickly and easily converted to cash (involving little or no loss of value) qualify as highly liquid assets. The rule also requires firms to impose a discount to the fair market value of an asset included in the liquidity buffer.

Contingency Funding Plan

The Proposed Rule requires firms to establish and maintain a contingency funding plan that includes a compilation of policies, procedures, and action plans for managing liquidity stress events. The Proposed Rule also requires plans to contain four components: a quantitative assessment, an event management process, monitoring requirements and testing requirements. This plan must track things like the covered company's capital structure, risk profile, complexity, and size, and is required to be updated annually or whenever market or other changes warrant update.

Specific Limits

The Proposed Rule requires covered companies to identify, establish and maintain limits on potential sources of liquidity exposure, including limits on funding source or instrument type concentration, the amount of liabilities that mature in close proximity, and off-balance sheet exposures.

Monitoring

The Proposed Rule requires covered firms to closely monitor liquidity risks across the firm.

Documentation

The Proposed Rule requires covered firms to adequately document all material aspects of liquidity risk management processes and compliance, and provide all such documentation to the risk committee.

Implications

- The initial impact for covered firms will be felt to the extent there are differences between their existing liquidity management efforts and the program that is required by the final rule. Firms with no programs or programs that differ significantly from the new rules will bear the costs of making the changes necessary to achieve compliance including for items such as hiring personnel and developing the required systems, policies and procedures.
- The new rules place a great deal of responsibility on the board of directors and the senior management. Boards of directors are given specific responsibilities and will have to take certain actions and conduct active oversight of senior management's efforts to meet those responsibilities.
- Before starting new businesses or selling new products, firms will be required to consider the liquidity implications of these new activities. At a minimum, this process will delay new initiatives, and, in some cases, will preclude such undertakings altogether.
- The liquidity buffer requires that firms hold an amount of low yielding, cash like assets. This will constrain return on assets and on equity, which will affect the firms' stock price.
- Overall, the proposed liquidity requirements place new responsibilities on boards and management, create additional expenses, limit flexibility, and will have an impact on firm returns.

Single-Counterparty Credit Limits

Background

Section 165(e) of Dodd-Frank directs the Board to establish single-counterparty credit concentration limits for covered companies in order to limit the risks that the failure of any individual firm could pose to a covered company. The Board must prescribe regulations that prohibit covered companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the covered company. The Board can lower the 25 percent threshold if necessary to mitigate the risks to the financial stability of the United States.

Two-Tier Limit

The Board has proposed a two-tier, single-counterparty credit limit with a more stringent single-counterparty credit limit applied to the largest companies: (i) there is a general limit that prohibits a covered company from having aggregate net credit exposure to any single unaffiliated counterparty in excess of 25 percent of the covered company's capital stock and surplus; and (ii) a more stringent net credit exposure limit prohibits a major covered company (a SIFI with total consolidated assets of $500 billion or more) from having aggregate net credit exposure to any major counterparty (a major covered company, as well as any foreign

banking organization that is or is treated as a bank holding company, and that has total consolidated assets of $500 billion or more) in excess of 10 percent of the major covered company's capital stock and surplus.

Several key concepts apply to both the general and more stringent limits, as hereinafter discussed.

Limits Apply to Covered Company and Controlled Subsidiaries

Both the general and more stringent limits apply to the combined exposures of the covered company and any of its controlled subsidiaries (including controlled investment funds sponsored by the covered company).

- For these purposes, "control" would exist when a covered company directly or indirectly: (i) owns or controls 25 percent or more of a class of that subsidiary's voting securities; (ii) owns or controls 25 percent or more of the subsidiaries' total equity; or (iii) consolidates the company for financial reporting purposes.
- This definition of control is similar to that in Appendix G of Regulation Y with the primary exception that, unlike the Appendix G definition, the proposed definition captures total equity.

As proposed, a fund or vehicle that is sponsored or advised by a covered company would not be "controlled" by the covered company, if two conditions are satisfied: (i) the company owns or controls less than 25 percent of the voting securities or total equity of the fund or vehicle; and (ii) such fund or vehicle would not be consolidated with the covered company for financial reporting purposes. Absent control, the exposures of such fund or vehicle to its counterparties would not be aggregated with those of the covered company.

- The Board sought comments from the public on whether or not the "fund carve-out" was appropriate, in light of the historical fact that, during the financial crisis, some companies provided support to funds they sponsored. Specifically, the Board cited to the example of the support provided by banking organizations to money market mutual funds, so as to enable those funds to meet investor redemption requests without having to sell fund assets into fragile and illiquid markets.

Definition of Counterparty

For purposes of both the general and more stringent limits, the term "counterparty" is broadly defined to include natural persons, entities, the United States (subject to the exemption noted below), any individual state, and any foreign sovereign entity, with no distinction made between a foreign sovereign entity and a private company for purposes of applying the limits.

- The credit exposure to the United States is exempt, if it represents direct claims on, and portions of claims that are directly and fully guaranteed as to principal and interest by (i) the United States and its agencies; (ii) Fannie Mae and

Freddie Mac, only while operating under the conservatorship or receivership of the Federal Housing Finance Agency; and (iii) any additional obligations by a U.S. government sponsored entity as determined by the Board.

Capital Stock and Surplus

As used in each limit, the term "capital stock and surplus" means the covered company's total regulatory capital (as calculated under applicable risk-based capital guidelines pursuant to Regulation Y) plus excess loan and lease loss reserves (i.e., those reserves not included in tier 2 capital under applicable Regulation Y guidelines).

- The Board raised the prospect of using common equity as an alternative measure of "capital stock and surplus," on the basis that this measure would be consistent with the post-crises global regulatory move toward tier 1 common equity as the primary measure of loss absorbing capital for internationally active banking firms.

Credit Exposure to a Company

Under each limit, "credit exposure to a company" may arise by virtue of a wide range of commercial transactions (i.e., loans, deposits, and lines of credit), financial transactions (i.e., securities lending or borrowing transactions, credit derivative or equity derivative transactions in which the covered company is the protection seller), and "credit transactions," as the term may be further defined by the Board.

- The Board sought comments on the valuation of credit exposure arising by virtue of investments in special purpose vehicles ("SPV"), such as collateralized debt obligations. Specifically, the Board noted that the failure to look through an SPV to its sponsor or the issuer of its underlying investments may mask a covered company's exposure to those parties. Under the proposal, the Board has reserved the authority to look through some SPVs to sponsor or the issuer of the underlying investments.

Measuring Credit Exposure

Each of the counterparty limits applies to a covered company's aggregate net credit exposure to a counterparty. The Proposed Rule defines "aggregate net credit exposure" as the sum of all net credit exposures of a covered company to a single counterparty. To determine the aggregate net credit exposure, a covered company will determine its "gross credit exposure" in respect of each credit transaction and then make adjustments for arrangements that reduce credit risk, such as netting arrangements, collateral and guarantees.

Gross Credit Exposure: The "gross credit exposure" measures the credit exposure to the counterparty for a "credit transaction" without regard to any credit risk mitigants. The term "credit transaction" is broadly defined to cover a wide variety of commercial

transactions (i.e., loans, deposits, and lines of credit) and financial transactions (i.e., securities lending or borrowing transactions, repurchase and reverse repurchase agreements, credit derivative or equity derivative transactions in which the covered company is the protection seller), in addition to direct investments by the covered company in securities issued by the counterparty. A covered company will be treated as having exposure to the issuer of any collateral provided to it by the counterparty or to any guarantor of a counterparty's obligations; however, in both cases, credit exposure to such issuer or guarantor, as applicable, is capped at the credit exposure to the original counterparty.

The Proposed Rule establishes valuation methodologies for each type of credit transaction.

- Under the proposal, repurchase agreements and securities lending transactions will be valued at a premium to the market value of the securities transferred or lent by the covered company to the counterparty. This premium, or "add-on," as it is referred to in the proposed rules, is intended to capture the market volatility (and associated potential increase in counterparty exposure) of the securities that are subject to the repo or securities lending transaction. The amount of each add-on is described in Table 2 of Proposed Rule at section 252.95.
- Valuations of derivative transactions vary as between transactions subject to a master netting agreement and those that are not. For transactions subject to a qualifying master netting agreement, the valuations are based upon "exposure at default," which can be described as an aggregate, portfolio level close-out calculation. If not subject to a master agreement, then each transaction is valued on the basis of current mark-to-market exposure, plus a potential future exposure or "PFE" calculation.
- Initial and variation margin posted to a counterparty is treated as "credit exposure" to that counterparty, unless held in a segregated account at a third-party custodian. For cleared derivatives, the contributions to a clearinghouse guaranty fund will be treated as credit exposure to the applicable clearing house.

- **Net Credit Exposure:** Under the proposal, gross credit exposure is converted to "net credit exposure" by taking into account any of the following: eligible collateral, unused credit lines, eligible guarantees, eligible hedges, and the effect of bi-lateral netting agreements among repurchase and reverse repurchase agreements, as well as securities lending and borrowing transactions, in each case entered into with a counterparty pursuant to a master netting agreement.
- **Eligible Collateral:** The proposal defines eligible collateral to include cash on deposit with a covered company (inclusive of cash held at a third-party custodian for the company's benefit); debt securities (other than mortgage backed and asset-backed securities) that are bank-eligible investments; and publicly traded equity or convertible securities. The covered company must have a perfected, first priority security interest in the collateral. The collateral will be subject to a valuation haircut prescribed in the rule, for purposes of the net credit exposure adjustment.
- **Unused Line of Credit:** Gross credit exposure may be reduced by the amount of an unused portion of a line of credit to the extent that the covered company does not have a legal obligation to advance additional funds under that facility until it receives qualifying security from the counterparty.

- **Eligible Guarantee:** Gross credit exposure should be reduced by the amount of any eligible guarantee from an eligible protection provider or "EPP," which includes broker-dealers, insurance companies and other banks.
- **Eligible Hedges:** Gross credit exposure can be reduced by the amount of eligible hedging transactions, which consist of credit and equity derivatives entered into by the covered company as a protection purchaser with an EPP. (The covered company will have credit exposure to the EPP, in respect of the hedging position.) To qualify as an eligible hedge, a credit derivative must be a single-name or untranched index product and an equity derivative must be a total return equity swap. A short sale of a counterparty's debt or equity security will also qualify as a hedge.

Timing

Initially, the proposed counterparty limits would not apply to any covered company until October 1, 2013. Thereafter, the proposed rule would apply to a covered company on the first day of the fifth quarter following the date on which it became a covered company.]

Implications

- The single-counterparty limits have potential, widespread effects upon financial institutions, their counterparties, and the broader financial markets, if such limits are enacted as proposed.
- Covered companies will face the increased cost of developing operational systems to monitor compliance with these new limits, many of which may not be covered by existing operational systems. Provisions such as the potential treatment of a money market mutual fund sponsored by a covered company as a subsidiary of that company could significantly increase the magnitude of the operational burden.
- Covered companies may place restrictions on the trading lines of their larger trade counterparties. At a minimum, it seems reasonable to assume that such counterparties may face different business conduct standards than smaller trade counterparties.
- The single-counterparty proposal almost certainly will contribute to the broader, market wide trend of collateralization, in general, and the use of higher quality collateral.
- Pricing in the repurchase agreement and securities lending markets could be affected, as a result of the significant volume of interbank transactional activity and the requirement in the proposal to measure counterparty exposure of these markets on the basis of a "premium" over market value (i.e., the add-on).
- Finally, there is even a potential disruptive effect to the liquidity of the derivatives and securities trading markets, because of the overall effect of financial market reform, such as the derivatives regulatory reforms under Title VII of Dodd-Frank and the Volcker Rule.

Risk Management

Background

In the research that preceded the Proposed Rule, supervisory authorities identified what they perceive to be systemic breakdowns in fundamental risk management processes. For example, regulators found that line of business management and senior management leadership failed to coordinate their efforts. Line of business managers often made risk management decisions on their own without regard to the implications such decisions may have on the broader firm, and treasury functions were not closely aligned with risk management. The proposed rule is part of a larger effort to instill a "risk management culture" among all financial institutions, but especially larger, systemically important financial institutions.

Section 165(h) of the Act directs the Board to issue regulations requiring publicly traded nonbank covered companies and publicly traded bank holding companies with total consolidated assets of $10 billion or more to establish risk committees. The Board may require those companies under $10 billion to establish a risk committee to promote sound risk management practices. Specifically, the Board is proposing to establish risk management standards that would: (i) require oversight of the enterprise risk management function by a stand-alone risk committee of the board of directors and a chief risk officer ("CRO"); (ii) reinforce the independence of a firm's risk management function; and (iii) ensure appropriate expertise and stature for the chief risk officer.

Structure and Responsibilities of the Risk Committee

Structure

The Proposed Rule sets forth certain structural and qualitative requirements for a risk committee. Specifically, the risk committee must: (i) have a formal, written charter, that is approved by the board of directors; (ii) have at least one member with risk management expertise that is commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk related factors; (iii) have a chairman who is "independent"; (iv) meet with appropriate frequency relative to the company's risk profile; and (v) maintain committee minutes. While the Proposed Rule requires that at least the chairman of the risk committee meet the independence standards typically required of an "independent director" under SEC Regulation S-K, the Board encourages companies generally to include additional independent directors as members of their risk committees.

Responsibilities

In general terms, a company's risk committee must document and oversee the enterprise-wide risk management policies and practices of the company. The Board expects risk committee members to generally have an understanding of the management principles and practices relevant to the company. The committee must review and approve a risk framework that is

commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. Additionally, the risk committee must be a stand-alone committee and not housed within another committee, such as the audit committee.

Chief Risk Officer

The Proposed Rule requires a covered company to appoint a CRO. The CRO must: (i) have risk management experience that is commensurate with the company's capital structure, risk profile, complexity, activities, size, and other risk-related factors that are appropriate; (ii) be appropriately compensated and incentivized to provide an objective assessment of the risks taken by the company; (iii) report directly to both the risk committee and the chief executive officer of the company; and (iv) directly oversee certain delineated enterprise-wide risk management responsibilities. The risk committee must also receive and review reports from the CRO on a regular basis.

Implications

Creating this risk management culture will be an on-going expectation of the Board. The Board will expect the risk framework to be engrained in the day-to-day culture of the company.

The Board will expect management to create an operating environment where issues are typically self-identified and resolved without regulatory persuasion.

Ultimately, the Board will expect the company's board of directors and management to continuously review and revise the risk management plan so as to ensure the establishment of effective communication channels, cultural change, discipline, and accountability.

Stress Testing Requirements

Background

The new stress testing requirements track the stress tests used in early 2009 in the Supervisory Capital Assessment Program and the current Comprehensive Capital Analysis Review. Two stress testing formats are proposed in the regulation: supervisory stress tests and company run stress tests. The supervisory stress tests involve the Board's analysis of the capital of each covered company, as well as its total consolidated capital, and an evaluation of the firm's ability to absorb losses as a result of adverse economic and financial conditions.

These tests are designed to work in tandem with the capital plan rule and are designed to provide information relating to the post stress test capital positions at covered companies. The internal stress tests are intended to provide additional forward looking information to supervisors to support assessments of a covered company's capital adequacy, identify risks and the potential impact of adverse outcomes, and assist in achieving financial stability.

Supervisory Stress Tests

- The Proposed Rule requires each covered firm to submit annually through the regulatory reporting process the data and information necessary to allow the Board to assess the impact of different economic and financial market scenarios on the consolidated capital of the company over a forward looking time period (at least nine quarters), taking into account all relevant exposures and activities of the firm.
- The primary data would be *pro forma* projections of capital positions (capital levels and regulatory and other capital ratios) for quarter-end for the nine covered quarters. The Board expects the data to be provided no later than 40 days after the end of each calendar quarter. The Board plans to issue a separate information collection proposal that will outline the specific data requirements.
- The Board will publish a minimum of three different economic/financial scenarios ("baseline," "adverse," and "severely adverse") that it will use to conduct its annual analysis. The scenarios would include projections for a range of macroeconomic and financial indicators, such as real GDP, unemployment rate, equity and property prices, and various other key financial variables. All covered firms will use the same scenarios.
- The results of the analyses will be provided to the covered companies "within a reasonable period of time," and summaries of the results will be made public.
- A schedule with the Proposed Rule indicates the Board's analysis will take about three months, and the results will be communicated to the covered companies around the fourth month with summaries published about one month thereafter.
- Upon completion of the tests, the Board will assess whether the covered companies have the total consolidated capital necessary to absorb losses in the designated scenarios.
- Covered companies will be required to take the results of the stress test into account in making changes to their capital structure, exposures, and risk positions. In addition, each covered company will need to update its "living will" as necessary within 90 days of the Board publishing the results of its analysis.

Company Directed Stress Tests

- The Proposed Rule requires covered companies and bank holding companies and state member banks that have more than $10 billion in consolidated assets to conduct their own internal stress tests. Savings and loan holding companies with $10 billion or more in consolidated assets will also have to conduct annual stress tests; however, these will be covered under a separate rule that will be promulgated later.

- Covered companies will be required to conduct two tests each year while the smaller firms above the $10 billion threshold but below the $50 billion amount, will only be required to conduct annual stress tests.
- The Proposed Rule defines company directed stress tests as "a process to assess the potential impact on subject entities of economic and financial conditions (the scenarios) on the consolidated earnings, losses and capital of the firm" over a set time frame, "taking into account the current condition of the company and the company's risks, exposures, business strategies and activities."
- The Board will provide to the companies at least three scenarios for the companies to use in their tests, which will be the same as the scenarios used by the Board in doing the supervisory stress tests. Again, the covered time frame is nine quarters.
- Each firm subject to the stress testing requirements will have to establish and maintain a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the company allow it to meet the requirements of the rule. The board of directors and management of the firms subject to the rule must approve and annually review these items.
- The firms, using the designated scenarios, must calculate for each of the nine required quarters the potential losses, pre-provision revenues, loan loss allowances, pro forma capital positions, as well as the impact of these scenarios on regulatory and any other capital ratios specified by the Board. The firms would have to report the results to the Board.
- The reports to the Board must contain certain qualitative and quantitative information. The Board will then review the information provided and, where appropriate, firms must take into account the results contained in the report when making changes to the firm's capital structure.
- For covered companies, which must undertake an additional company run stress test, they must develop and apply their own developed scenarios, reflecting a minimum of three sets of economic and financial conditions – baseline, adverse and severely adverse – or such additional conditions as the Board determines are appropriate. The firms must publish a summary of the results within 90 days of submitting the report to the Board.

Implications

- Unlike the *ad hoc* stress tests used in the past few years, the new requirements are permanent and involve regular testing. Covered firms will therefore have to hire personnel and set up the systems, policies and procedures to meet these requirements.
- The use of stress testing introduces a very novel concept to bank regulation: Regulators and covered firms will take real world actions based on outcomes using hypothetical scenarios. Such actions may not be constrained to the margins.
- Stress test results could serve as the basis for significant capital charges if regulators conclude that a firm's test results indicate deficiencies. The use of stress tests involving hypothetical scenarios brings into question the assumptions and potential biases built into the models. On the one hand, if the models over-predict negative outcomes, firms could be required to take expensive and unnecessary actions. On the other hand, if the models under predict negative outcomes, firms could be lulled into a false sense of security.

- Flawed models that do not provide predictive results must be avoided. Regular assessments of the models will be a key aspect of ensuring that the stress tests provide worthwhile results.
- Finally, firms will have to be prepared to deal with the fact that publication of the test results will increase scrutiny of all aspects of firm activities and management decision making.

Debt-to-Equity Limit

Requirements

The Proposed Rule requires a covered company to achieve and maintain a debt-to-equity ratio of no more than 15-to-1 when the Council determines that: (i) such covered company poses a grave threat to the financial stability of the United States (an "identified company"), and (ii) the imposition of the specified debt-to-equity requirement is necessary to mitigate such risk. An identified company would be given 180 days from the date of receipt of the Council's notice of such determination to comply with the 15-to-1 debt to equity ratio requirement, unless the Board extends the time for compliance because it finds such extension is in the public interest.

Definitions

Under the Proposed Rule, "debt" and "equity" have the same meaning as "total liabilities" and "total equity capital," respectively, as set forth in the identified company's reports of financial condition. The Board's commentary for this section states that the Proposed Rule does not require an identified company to take any specific actions to comply with the debt-to-equity ratio requirement, and that the Board would expect compliance in a manner generally consistent with safe and sound operation and financial stability.

Extension of Time

An identified company would have the ability to request an extension of time to comply with the debt-to-equity ratio requirement for up to two additional periods of 90 days each. In order to grant such an extension, the Board must determine that the identified company has made good faith efforts to comply with the debt to-equity ratio and that each extension would be in the public interest. Once a debt-to-equity ratio is imposed on an identified company, it would remain in effect until the Council notifies such company that it no longer poses a threat to the financial stability of the United States, and the debt-to-equity requirement is no longer necessary for such company.

There is no specific set of actions that a company must take to comply with the debt to equity ratio requirement; however, a company is expected to come into compliance in a manner that is consistent with the company's safe and sound operation and preservation of financial stability.

Implications

- If a covered company poses a "grave threat to US financial stability" its ability to reduce its leverage will be severely constrained by the marketplace's likely reaction.
- Management may need to quickly adjust the covered company's business model, which will likely include significant divestitures.

Early Remediation

Background

In the shadow of the financial crisis that has loomed over financial institutions large and small during the past almost four years, section 166 of Dodd Frank was enacted to address the potential reality that the financial well being of a financial institution can deteriorate rapidly, even during periods when its reported capital ratios are well above minimum requirements. It was believed, as detailed in a GAO study, that the Prompt Corrective Action triggers, based primarily on a capital ratio that had to be below "adequately capitalized," was too much of a lagging indicator.

Section 166 of Dodd Frank was designed to provide early remediation measures to stabilize financial weakness, and to ensure that the remedial action is directly correlated to the severity of an institution's condition. The proposed early remediation requirements that are triggered once a covered company's capital levels fall below the well capitalized threshold, would employ a range of actions, including: (i) limits on capital distributions, acquisitions and asset growth in the early stages of financial decline, and (ii) capital restoration plans, capital raising requirements, limits on transactions with affiliates, management changes, and asset sales in the later stages of financial decline.

The proposed early remediation rules establish a regime for the pro-active remediation of financially distressed covered companies with the stated objective of identifying the emergence of potential issues before they develop into larger problems. The remediation rules consist of the manifestation of triggering events in five categories of covered companies' operations, namely: (i) risk-based capital/leverage, (ii) stress tests, (iii) enhanced risk management and risk committee standards, (iv) enhanced liquidity risk management standards, and (v) market indicators.

Following the occurrence of a triggering event, it is then incumbent upon both the covered company and the Board to determine the appropriate level and nature of remediation required to address the realized distress. The "level" assigned to the applicable triggering event will then determine the form of remediation under which a covered company is subject. For example, a "Level 1" triggering event will subject a company to the lowest form of remediation, whereas a "Level 4" triggering event will subject a company to the broadest and most stringent form of remediation. The four levels of remediation ("Remediation Levels") are:

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1. **Heightened Supervisory Review**, in which the Board conducts targeted reviews of the covered companies to determine the appropriate level of remediation
2. **Initial Remediation**, in which a covered company is subject to restrictions on growth and capital distributions
3. **Recovery**, in which a firm is subject to prohibitions on growth, capital distributions, limits on executive compensation, and requirements to raise additional capital and other possible requirements
4. **Recommended Resolution**, whereby the Board recommends to Treasury and the FDIC to involve Title II's orderly liquidation authority

The Proposed Rules provide that the Board shall notify covered companies upon initiation of each level of remediation, and covered companies shall remain subject to the applicable remediation level requirements or restrictions until notified by the Board that such requirements or restrictions no longer apply. Covered companies would also have an affirmative duty to notify the Board of remediation triggers and changed circumstances that may affect the remediation requirements applicable to them.

The following table provides a summary of all proposed triggers and associated remediation actions:

Capital and Leverage	**Level 1:** Total Risk-Based Capital Ratio of 10% or greater; Tier 1 Risk-Based Capital Ratio of 6% or greater; and Tier 1 Leverage Ratio of 5% or greater (i.e., meets all risk based and leveraged requirements for a well capitalized company), **but** the Board determines that the covered company's capital structure, capital planning processes, or the amount of capital it holds is not commensurate with the risks to which the company is exposed.
	Level 2: Total Risk-Based Capital Ratio of less than 10% and greater than or equal to 8%; Tier 1 Risk-Based Capital Ratio of less than 6% and greater than or equal to 4%; or Tier 1 Leverage Ratio of less than 5% and greater than or equal to 4% i.e., fails to meet any one of the Level One capital levels.
	Level 3: (a) For two consecutive quarters, a Total Risk-Based Capital Ratio of less than 10%; Tier 1 Risk-Based Capital Ratio of less than 6%; or Tier 1 Leverage Ratio of less than 5%, or (b) Total Risk-Based Capital Ratio of less than 8% and greater than or equal to 6%; Tier 1 Risk-Based Capital Ratio of less than 4% and greater than or equal to 3%; or Tier 1 Leverage Ratio of less than 4% and greater than or equal to 3%.
	Level 4: Total Risk-Based Capital Ratio of less than 6%; Tier 1 Risk-Based Capital Ratio of less than 3%; or Tier 1 Leverage Ratio of less than 3%.
Stress Tests	**Level 1:** Noncompliance under severely adverse stress scenario with the Board's capital plan and stress test

regulations.

	Level 2: Results under the severely adverse scenario with respect to a stress test in any quarter of the planning horizon reflect a Tier 1 Risk-Based Capital Ratio of less than 5% and greater than or equal to 3%.
	Level 3: Results under the severely adverse scenario with respect to a stress test in any quarter of the planning horizon reflect a Tier 1 Risk Based Capital Ratio of less than 3%.
Risk Management	**Level 1**: Company manifests ***signs of weakness*** in meeting enhanced risk management and risk committee requirements.
	Level 2: Company demonstrates ***multiple deficiencies*** in meeting enhanced risk management and risk committee requirements.
	Level 3: Company is in ***substantial noncompliance*** with the enhanced risk management and risk committee requirements.
Liquidity	**Level 1:** Company manifests ***signs of weakness*** in meeting enhanced liquidity risk management requirements.
	Level 2: Company demonstrates ***multiple deficiencies*** in meeting enhanced liquidity risk management requirements.
	Level 3: Company is in ***substantial noncompliance*** with the enhanced liquidity risk management requirements.
Market Indicators	**Level 1:** Board will identify market based triggers that should provide an early signal of deterioration in a firm's financial condition that will prompt heightened supervisory review.

Level 1 Remediation or Heightened Supervisory Review – The first level of remediation is heightened supervisory review. This review is triggered if the Board determines that the company is experiencing financial distress or material risk management weaknesses, such that further decline is probable. Within 30 days, the Board will prepare a report on the elements evidencing deterioration and determine whether the institution should be elevated to a higher level of remediation. The Board may also use other supervisory authority to cause the covered company to take appropriate actions to address the problems reviewed by the Board.

Level 2 Remediation or Initial Remediation – A covered company subject to Level 2 remediation should undertake remediation measures that include limits on capital distributions, acquisitions and asset growth, as described in more detail below. Specifically, a covered company:

- Is not permitted to distribute in any calendar quarter more than 50 percent of the average of its net income for the preceding two calendar quarters
- Cannot permit its daily average total assets and daily average total risk weighted assets during any calendar quarter to exceed its daily average total assets and daily average total risk weighted assets, respectively, during the preceding calendar quarter by more than 5% percent
- Cannot permit its daily average total assets and daily average total risk weighted assets during any calendar year to exceed its daily average total assets and daily average total risk weighted assets during the preceding calendar year by more than 5% percent
- Will not, without Board approval, directly or indirectly acquire any controlling interest in any company (including an insured depository institution), establish or acquire any office or other place of business, or engage in any new line of business (although non-controlling acquisitions, such as the acquisition of less than 5 percent of the voting shares of a company, generally will not require prior approval)
- Will be required to enter into a non-public memorandum of understanding, or other enforcement action acceptable to the Board
- May be subject to limitations or conditions, in the Board's discretion, on the conduct or activities of the company or any of its affiliates.

  The restriction on capital distributions under a Level 2 remediation shall apply to all capital distributions (common stock dividends and share repurchases) and is intended to ensure that covered companies preserve capital through retained earnings during the earliest periods of financial stress. It is also intended to build a capital cushion to absorb losses that the covered company may continue to accrue, and allow some room to pay dividends and repurchase shares. Furthermore, the restrictions on asset growth are intended to prevent covered companies from growing at a rate inconsistent with preserving capital, and to focus on resolving material financial or risk management weaknesses. The 5 percent limit should be consistent with reasonable and normal growth in business.

Level 3 Remediation or Recovery – A covered company that is subject to Level 3 remediation is in advanced stages of financial stress and should implement remediation actions that include a capital restoration plan and capital raising limits on transactions with affiliates, management changes and asset sales. Accordingly, a covered company that has entered Level 3 remediation will be subject to a number of fixed limitations:

- No capital distributions
- No increases in compensation of pay and bonus to senior executive officers or directors

- Shall not permit its average total assets or average risk weighted assets during any calendar quarter to exceed its average total assets or average total risk weighted assets during the preceding calendar quarter
- Shall not, directly or indirectly, acquire any interest in any company (including an insured depository institution), establish or acquire any office or other place of business, or engage in any new line of business

- Must enter into a written agreement or other form of enforcement action with the Board that specifies the company must raise additional capital and take other appropriate actions to improve its capital adequacy. If the company fails to comply, the Board may require the company to divest assets identified by the Board as either having contributed to the covered company's financial decline or that pose substantial risk of contributing to the company's further financial decline
- May be required by the Board to conduct a new election for the institution's board of directors, dismiss any director or senior executive officer of the company who had held office for more than 180 days immediately prior to receipt of notice that the company was subject to Level 3 remediation, employ qualified senior executive officers approved by the Board and comply with restrictions applicable to the company's transactions with affiliates
- May be subject to the Board taking appropriate action to ensure that company's management could not increase the risk profile of the company or make its failure more likely.

Level 4 Remediation or Recommended Resolution – The Board will consider whether the covered company poses a risk to the stability of the U.S. financial system. If the Board determines, based on the company's financial decline and the risk posed to U.S. financial stability by the failure of the company or other relevant factors, that the company should be resolved under the orderly liquidation authority in Title II of Dodd-Frank, the Board will make a written recommendation to the Treasury Department and the FDIC that the company be placed into resolution under Title II of the Act for its orderly liquidation.

Market-Based Indicators

In addition to the foregoing remediation measures, to implement the statutory requirement that remediation triggers include "other forward-looking indicators," the Board proposes to specify a variety of market-based triggers designed to capture both emerging idiosyncratic and systemic risk. The Board's rule sets out the initial set of market based indicators it proposes to use in its early remediation framework. They are: Expected default frequency, marginal expected default, market equity ratio, option implied validity, audit default swaps and subordinated debt (bond) spreads. The Board will publish for notice and comment the market based triggers on an annual basis, since the informational content and availability of market data will change over time.

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Implications

- While the triggering mechanism for Prompt Corrective Action may have been too late to prevent failure, the remediation steps, particularly starting at Level 2 may result from false positives that lead to an eventual failure that may have been avoided.
- The triggers for involving remediation action steps are quite subjective and accord examiners broad discretionary authority.
- The extent to which the remediation action steps are covered by the examination privilege is critical and may determine whether the covered firm recovers or becomes subject to Level 4 remediation.

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