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January 2012 / Special Alert

A legal update from Dechert's Financial Institutions Group

SLHC UPDATE

The Federal Reserve's Enhanced Prudential and Early Remediation Requirements: The Impact on Savings and Loan Holding Companies

The Federal Reserve Board (FRB) last month issued proposed rules (Proposal) to implement the enhanced prudential standards and early remediation requirements of Sections 165 and 166 of the Dodd-Frank Act. The Proposal — which generally applies to large (greater than $50B in assets) bank holding companies (BHCs) and nonbank financial companies designated as systemically significant (SIFIs) by the Financial Stability Oversight Council (FSOC) (collectively, Covered Companies) — also includes provisions of particular relevance to savings and loan holding companies (SLHCs). This summary provides a high level overview of the Proposal and its impact on SLHCs.

The Enhanced Prudential and Early Remediation Proposal

Enhanced Prudential Requirements

The Proposal imposes prudential standards on Covered Companies in the following areas.

Risk-Based Capital and Leverage

The Proposal would require all Covered Companies to comply with the FRB's capital plan rule, which was adopted in November 2011. Under the capital plan rule, Covered Companies would be required to demonstrate their ability to maintain capital above existing minimum regulatory capital ratios applicable to BHCs and above a Tier 1 common ratio of 5% under both expected and stressed conditions over a minimum nine-month planning horizon. Capital plans must be submitted on an annual basis and are subject to FRB review and approval. Covered Companies with unsatisfactory capital plans would be subject to limits on their ability to pay dividends. In a subsequent proposal, the FRB intends to implement a quantitative risk-based capital surcharge on Covered Companies (or a subset of Covered Companies) consistent with the Basel III approach and implementation timeframe.

Liquidity

The Proposal would subject Covered Companies to comprehensive liquidity risk management standards, including liquidity stress testing. Among other things, the Proposal would require Covered Companies to conduct internal stress tests at least monthly to measure their liquidity needs at 30-day, 90-day and one-year intervals during times of financial instability and to hold a "liquidity buffer" of unencumbered highly liquid assets that would be sufficient to meet projected net cash outflows over 30 days over a range of liquidity stress scenarios. Through a separate proposal, the FRB intends to supplement these requirements with the liquidity requirements (Liquidity Coverage Ratio and Net Stable Funding Ratio) included in the Basel III regime.

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Single-Counterparty Credit Limits

The Proposal would prohibit a Covered Company from having aggregate net credit exposure to an unaffiliated counterparty in excess of 25% of its capital. A more stringent 10% limit would apply to very large BHCs (in excess of $500B in assets) and nonbank companies designated as SIFIs with respect to their credit exposures to other very large BHCs and nonbank SIFIs.

Risk Management

The Proposal would require each Covered Company and each publicly-traded BHC with assets greater than $10B to establish a risk committee of the board of directors to oversee, on an enterprise-wide basis, the risk management practices of the company's worldwide operations. The risk committee must have at least one member with risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities and size. A Covered Company must also employ a chief risk officer who would report directly to both the risk committee and the CEO of the company.

Stress Tests

The Proposal would require the FRB to conduct annual stress tests of Covered Companies ("supervisory stress tests") under three sets of economic conditions (baseline, adverse and severely adverse) in order to assess a Covered Company's capital adequacy and ability to absorb losses under stressed market conditions. The Proposal would also require Covered Companies *as well as BHCs, SLHCs and state member banks with greater than $10 billion in assets* to conduct their own stress tests ("company-run stress tests") to assess capital adequacy. Company-run stress tests must be conducted on a semi-annual basis by Covered Companies and on an annual basis by over $10 billion companies. Companies must take the results of the supervisory and company-run stress tests into account when evaluating the adequacy of their capital structure, including the level and composition of their capital. Summary results of the supervisory and company-run stress tests must be disclosed publicly. The Proposal exempts SLHCs from the annual company-run stress test requirements until the FRB establishes risk-based and leverage capital requirements for SLHCs.

Early Remediation Requirements

The Proposal also establishes a regime for the early remediation of financial distress at Covered Companies that includes four levels of remediation. In general, the nature of the remedial actions increase in stringency as the financial condition of a Covered Company deteriorates. The four levels of remediation are:

- Heightened Supervisory Review (Level I) – At this level, the FRB would conduct a targeted review of the Covered Company to determine if it should be moved to the next level of remediation.
- Initial Remediation (Level II) – At this level, a Covered Company would be subject to restrictions on growth and capital distributions.
- Recovery (Level III) – At this level, a Covered Company would be subject to a prohibition on growth and capital distributions, limits on executive compensation, requirements to raise additional capital and additional requirements on a case-by-case basis.
- Recommended Resolution (Level IV) – At this level, the FRB would consider whether to recommend to Treasury and the FDIC that the Covered Company be resolved under the orderly liquidation authority of Title II of Dodd-Frank.

Covered Companies will be placed in one of the remediation levels upon the occurrence of specified triggering events. The triggering events are based on risk-based and leverage capital ratios, the results of supervisory stress tests, compliance with enhanced risk management and liquidity standards and market indicators.

Impact of the Proposal on SLHCs

While the Proposal does not specifically apply to SLHCs (except for company-run stress tests), it may impact SLHCs in various ways:

- An SLHC would become a Covered Company and subject to the enhanced prudential standards and early remediation requirements if it were designated as a SIFI by the FSOC. The FSOC has issued proposed rules regarding its process for designating a non-bank financial company as a SIFI. That proposal has not yet been finalized.
- Relying on its authority under the Home Owners' Loan Act, the FRB states in the preamble to the Proposal that it intends to issue a separate proposal for notice and comment to apply the enhanced prudential standards and early remediation requirements to large SLHCs (greater than $50B in assets) with substantial banking activi-

ties. This would include large SLHCs that (i) have savings association subsidiaries that comprise 25% of the SLHC's total consolidated assets or (ii) controls one or more savings association subsidiaries with total consolidated assets of $50B or more. As a result, large SLHCs and large BHCs would be treated similarly with respect to application of the enhanced prudential and early remediation requirements. Notably, under this formulation, large grandfathered unitary SLHCs with relatively small thrift operations — which includes a number of commercial, retail and insurance SLHCs — would not become subject to the enhanced requirements unless they were otherwise designated as a SIFI by the FSOC.

- As noted, SLHCs with greater than $10B in assets would be required to conduct annual company-run stress tests, once the FRB adopts capital requirements for SLHCs. The stress tests must calculate the impact on an SLHC's potential losses, revenues, ALL and capital positions over a minimum of nine quarters under baseline, adverse and severely adverse economic scenarios. Results of the stress tests must be reported to the FRB and will likely become a significant regulatory tool in evaluating an SLHC's capital, exposures, concentrations and risk positions.

- Over time, the enhanced prudential requirements may come to be viewed as "best practices" and may be applied by the FRB to smaller SLHCs and BHCs. The FRB signals this possibility by stating in the Proposal that it may determine to apply the enhanced prudential standards to *any* SLHC or BHC on a case-by-case basis if appropriate to ensure the safety and soundness of the institution. Thus, to stay ahead of the regulatory curve, it would be prudent for all SLHCs to become familiar with the enhanced prudential requirements and, to the extent feasible, incorporate them into their operations and risk management framework.

Comments on the Proposal are due March 31, 2012.

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If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/financial_institutions.

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