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Federal Reserve Board Proposes Heightened Prudential Requirements for Large Bank Holding Companies and Non-Bank SIFIs

On December 20, 2011, the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued a long-awaited proposed rule pursuant to Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") designed to apply "more stringent" supervision and prudential standards to bank holding companies ("BHCs") and non-bank financial companies that have the potential to pose significant risks to the financial stability of the United States.

Overall, the proposal, entitled "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,"[1] provides the architecture for the imposition of these heightened prudential standards on companies targeted by the Dodd-Frank Act. However, significant details and further construction of the framework is left to future proposals, so development of key compliance policies, infrastructure and reporting may have to wait for the integration of those future proposals into this initial framework.

The proposal does, however, take the helpful tack of integrating, building on, and attempting to harmonize several important U.S. and international regulatory initiatives developed in response to the recent financial crisis. The proposal would bring together a number of capital, risk management, stress testing and overall safety and soundness developments into a comprehensive and integrated framework. The result, however, would expand and further complicate the overall compliance burdens on large, complex financial organizations. Indeed, the Federal Reserve explicitly acknowledges its desire that the proposal "provide incentives for covered companies to reduce their systemic footprint . . ."

This memorandum provides a high-level analysis of, and highlights certain key issues throughout, the proposal. The Federal Reserve has requested comments by March 31, 2012.

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[1] The proposal can be found at http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm.

Scope

Covered Companies. Under the Dodd-Frank Act, the Federal Reserve is required to apply the more stringent supervisory and prudential standards to the following companies ("Covered Companies"):

- All BHCs with total consolidated assets equal to or greater than $50 billion; and

- All non-bank financial companies designated as systemically important by the Financial Stability Oversight Council (the "FSOC") under Section 113 of the Dodd-Frank Act ("Non-Bank SIFIs").

As proposed, the Federal Reserve would generally apply the same standards to the Non-Bank SIFIs as it would apply to the large BHCs, although the Federal Reserve notes that it would have discretion to tailor the application of the rules based on the attributes of individual companies.

Foreign Banking Organizations. The current proposal does not include a framework applicable to foreign banking organizations ("FBOs") that may be Covered Companies, but the Federal Reserve stated that it will issue "shortly" a separate proposal on the application of heightened standards to FBOs. The current proposal would, however, apply to any U.S.-based BHC subsidiary of a FBO that meets the applicable thresholds, although intermediate U.S. BHC subsidiaries of FBOs that rely on Federal Reserve SR Letter 01-01 would generally be exempt from all requirements other than the liquidity and risk management provisions until July 21, 2015.

Savings and Loan Holding Companies. Although Sections 165 and 166 do not, by their terms, apply to savings and loan holding companies ("SLHCs") unless a SLHC is designated as a Non-Bank SIFI, the Federal Reserve has proposed:

- to apply the stress testing requirements of the proposed rule to SLHCs that have over $10 billion in total consolidated assets, but only after the Federal Reserve has established risk-based capital requirements for such companies; and

- to issue, at a future date, a proposal to apply the enhanced standards to large SLHCs with "substantial banking activities."

Stress Testing. In accordance with Section 165(i)(2) of the Dodd-Frank Act, annual stress testing requirements would apply to all financial companies that have greater than $10 billion in total consolidated assets and that are regulated by the Federal Reserve (including state member banks, BHCs and SLHCs).

Risk Committee. Risk Committee requirements would also apply to publicly traded BHCs that have over $10 billion in total consolidated assets.

Reservation of Authority. The Federal Reserve notes that it would retain discretion to apply heightened standards to other BHCs and entities under its jurisdiction.

Timing of Effectiveness. The Appendix to this memorandum contains a chart setting forth the time frames within which different entities would become subject to the heightened standards in the proposed rule.

Risk-Based Capital Requirements and Leverage Limits

The proposal incorporates by reference the Federal Reserve's capital plan rule and its effective requirement that covered BHCs maintain a Tier 1 Common to risk-weighted assets ratio of 5% under both expected and stressed scenarios, but would not impose any new capital requirements on Covered Companies that are BHCs.

For Non-Bank SIFIs, on the other hand, the proposal would likely mean a profound transformation of their capital regulation. Most Non-Bank SIFIs are not currently subject to formal consolidated capital requirements. The proposal would require a Non-Bank SIFI to meet the minimum capital requirements applicable to covered BHCs, including the Federal Reserve's capital plan rule, within 180 days of its designation as a Non-Bank SIFI by the FSOC. The proposal would also impose quarterly reporting requirements on Non-Bank SIFIs, although the form of disclosure and whether such reports would be made public is not addressed.

The proposal also gives little indication as to how the Federal Reserve plans to implement the Basel Committee's capital surcharge framework for global systemically important banks ("G-SIBs"), noting only that a separate proposal will be issued targeting adoption of implementing rules by 2014 and requiring G-SIBs to meet any capital surcharge on a phased-in basis from 2016 to 2019. The proposal seems to indicate an intent not to get ahead of this international decision-making, perhaps with competitive equity considerations in mind. As a result, it does not address key questions, such as whether or to what degree a capital surcharge over and above the Basel III minimum requirements will be imposed on all Covered Companies or only on those financial institutions that are identified as G-SIBs by the Basel Committee and the Financial Stability Board (expected to be a much smaller subset of approximately eight U.S. institutions).

Liquidity Requirements

The proposal would require Covered Companies to maintain a liquidity buffer well before Basel III would otherwise phase in similar requirements, although the Federal Reserve expects these provisions would be amended in the future as the Basel Committee and the U.S. regulatory agencies study, finalize and adopt appropriate liquidity metrics. This liquidity buffer must consist of "unencumbered highly liquid assets sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios." The proposal's definition of "highly liquid assets" that may be used to satisfy the liquidity buffer is much broader than the Basel Committee's proposal for the Liquidity Coverage Ratio ("LCR") because it would include agency mortgage-backed securities without limit as well as "other instruments" that the preamble suggests could include "plain vanilla" corporate bonds. Accordingly, the proposal seems to confirm that the Federal Reserve is responsive to industry concerns about the restrictive nature of the LCR and may presage similarly favorable revisions to the Basel III liquidity proposal.

Reflecting an emphasis on robust risk management, the proposal also would require a Covered Company's board of directors to be directly involved in establishing the Covered Company's liquidity risk tolerance and in reviewing and approving the Covered Company's contingency funding plan. Additional significant planning, review and analysis responsibilities would be given to the Covered Company's board of director-level Risk Committee and to senior management of the organization. The proposal also would require liquidity stress testing at least monthly, or more frequently as conditions warrant. All these requirements would be a matter of formal regulation, and not merely guidelines or interpretations.

Single-Counterparty Credit Limits

Consistent with the mandate under the Dodd-Frank Act, the proposal would impose enterprise-wide limits on a Covered Company's credit exposure to a single counterparty, and would require Covered Companies to include the exposure resulting from derivatives and other transactions not historically included in lending limits under U.S. regulations. In general, the proposal would impose the statutory credit exposure limit of 25% of a Covered Company's total capital and surplus. However, a more stringent limit of 10% of total capital and surplus would be imposed on credit exposures incurred by a Covered Company that has more than $500 billion in total consolidated assets to either (a) another BHC or FBO with more than $500 billion in total consolidated assets or (b) any Non-Bank SIFI. In other words, the proposal would significantly limit the credit exposures that the largest organizations may have to one another.

The contours of "credit exposure" would be defined in a potentially more sophisticated way than existing legal lending limit constructs. Although the exceptions to the proposed framework are not quite as broad and varied as those created over the years by the Office of the Comptroller of the Currency (the "OCC"), the Federal Reserve does propose a "net" credit exposure concept that would permit offsetting collateral, guarantees and credit and equity derivatives to be taken into account (albeit with a proposed "shifting" of the credit exposure to the collateral issuer, guarantor or protection provider).

The proposal includes methodologies for calculating exposure under a variety of transactions. A key question will be whether such methodologies reflect techniques commonly used by the industry for risk management and risk limit purposes. If not, Covered Companies may have to embark on significant compliance and technological efforts in order to capture exposures under multiple methodologies. Certainly, the development of consistency with currently used risk analyses would be appropriate for comment by the industry.

It is also unclear whether the regulatory agencies will seek to harmonize credit exposure calculations across multiple disparate regulations. Whether the industry believes such harmonization would be in its best interest is highly dependent upon the resulting impact of each particular regulation. The Federal Reserve and the Federal Deposit Insurance Corporation have already postponed finalization of the credit exposure reporting rules so as to make them consistent with any final credit limit rules for Covered Companies. However, the regulatory agencies' proposal on initial margin for uncleared swap transactions contained a different method of calculating the potential future exposure of derivatives from the method described in this proposal. It is also still unclear whether the Federal Reserve and the OCC will adopt similar methodologies for revisions to the affiliate transaction and legal lending limit rules, respectively, mandated by the Dodd-Frank Act.

Stress Testing Requirements

The proposal incorporates two stress testing requirements: (a) supervisory stress tests that would require Covered Companies to submit a range of data annually to enable the Federal Reserve to estimate net income, losses, and pro forma capital ratios, and (b) semi-annual internal stress tests that would apply more broadly to Covered Companies, as well as to BHCs, SLHCs, and state member banks that are not Covered Companies but have more than $10 billion in total consolidated assets. Specific data collection requirements will be proposed in the future.

The supervisory stress test methodology is a further refinement of the Federal Reserve's Comprehensive Capital Analysis and Review, to which the largest 19 BHCs are currently subject. While the proposal provides additional procedural detail, there is little insight into how the Federal Reserve will evaluate a Covered Company's performance and, specifically, how projected losses under stress scenarios will be calculated. The proposal is also silent on whether contingent capital instruments could provide effective loss absorption for purposes of either the internal or supervisory stress tests, even if they are not viewed as regulatory capital with respect to minimum requirements.

Early Remediation Framework

The proposal would apply an early remediation regime to Covered Companies, as mandated by the Dodd-Frank Act. The regime would update and expand on the current prompt corrective action ("PCA") regime for insured institutions under the Federal Deposit Insurance Act, which the Federal Reserve notes was found to suffer from "fundamental weaknesses" during the financial crisis.

Triggers that could result in early remediation fall into five categories: risk-weighted capital and leverage, stress test results, compliance with risk management requirements, compliance with liquidity management requirements, and market indicators. Capital and leverage triggers would lead to mandatory remediation actions beginning once a Covered Company falls below the "well capitalized" level, earlier than the corresponding requirements under PCA. If triggers are hit, a Covered Company could be placed in one of four increasingly restrictive remediation levels.

The market indicator triggers are intended to provide a forward-looking predictor of likely financial difficulties based on metrics that are found in the marketplace, such as credit default swap pricing data or subordinated debt spreads over treasuries. The use of market indicators will be the subject of further proposals with opportunity for comment. Market indicators could potentially be a source of ambiguity as different market participants and informational services publish varied metrics based on their own research. Helpfully, however, the Federal Reserve notes that market indicators would be used only to begin consideration of the first remediation stages, and not to place a Covered Company into a more restrictive remediation level.

Many of the consequences of triggering early remediation would be mandatory, resulting in little or no discretion on the part of the Federal Reserve. The most salient constraints include restrictions on growth and on capital distributions, and limited or no ability to acquire a controlling interest in any company (including pursuant to merchant banking) or to establish a new office or line of business. Placement into higher remediation levels would result in more severe constraints, including mandatory limits on compensation increases and bonuses and potentially changes to the board or executive officers of a Covered Company.

Interestingly, some of the consequences under early remediation would appear to be stricter and less discretionary than those the Federal Reserve has imposed under similar remediation scenarios in current regulation.

Risk Management and Risk Committee Requirements

The proposal would require that Covered Companies and publicly traded BHCs with over $10 billion in total consolidated assets establish a board of directors-level Risk Committee chaired by an independent director. Covered Companies would also have to appoint a Chief Risk Officer with appropriate independence and expertise. Although relatively simple in concept, these requirements would carry the force of regulation, rather than safety and soundness guidance. Furthermore, these provisions take on added significance because any weaknesses or deficiencies in implementing these requirements can trigger the early remediation framework described above.

Debt-to-Equity Limits for Certain Covered Companies

The proposal would authorize the Federal Reserve to impose a maximum 15-to-1 debt-to-equity ratio on a Covered Company under certain limited circumstances. As a practical matter, this limit should be imposed rarely, if ever, because a Covered Company would only be subject to the limit if the FSOC first determines that the company "poses a grave threat to the financial stability of the United States and that the imposition of such requirement is necessary to mitigate the risk that such company poses to the financial stability of the United States." However, it is highly likely that the Federal Reserve would implement the early remediation provisions of the proposed rule (described above) well before such a high standard is met.

Other Points of Interest

Below we list certain other key points that may be of interest to Covered Companies and other financial institutions:

- The Federal Reserve chose not to propose certain additional standards that were authorized by the Dodd-Frank Act, but not required. These include contingent capital, enhanced public disclosure and short-term debt limit requirements.

- To date, the FSOC has not designated any companies as Non-Bank SIFIs. Therefore, at this stage, preparing for compliance with, and potentially commenting on, this proposal may prove difficult for providers of non-bank financial services.

- While the requirements will initially apply only to Covered Companies, as a practical matter over time regulators may come to see some or all of these requirements as "best practices" and may expect smaller institutions to conform to similar requirements.

- The Federal Reserve seeks comment on a number of aspects of the proposal, posing a total of 95 questions (although not nearly so many as set forth in the proposed regulation to implement the Volcker Rule). Comments are due by March 31, 2012.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Banking and Financial Institutions" in the Practices section of our website at http://www.cgsh.com.

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Timing Considerations: Application of Enhanced Prudential Standards to Covered Companies

This chart sets forth the dates on which the various requirements of the proposed rule will be applied to Covered Companies. Large SLHCs will also be subject to enhanced prudential standards (including stress tests for SLHCs with more than $10 billion in total consolidated assets), but the Federal Reserve has postponed application of enhanced prudential standards to SLHCs until after the Federal Reserve has established risk-based capital requirements for SLHCs. The Federal Reserve intends to issue a separate proposal on enhanced prudential standards for SLHCs.

Proposed Rule Requirements	Bank Holding Companies	Designated Non-Bank SIFIs
Risk-Based Capital Requirements and Leverage Limits	Rule applies from the **first day of the fifth quarter following the effective date**. For BHCs that become Covered Companies after the effective date, the rule applies from the **first day of the fifth quarter following the date on which the BHC became a Covered Company**.	Risk-based and leverage capital requirements apply the **later of the effective date or 180 days** following designation. Capital-plan and stress-test requirements apply from **September 30 of the year in which a company is designated**, if the company was designated at least 180 days before September 30 of that year.
Single-Counterparty Credit Limits	Rule applies from **October 1, 2013**, for BHCs that are Covered Companies on the effective date or become Covered Companies before September 30, 2012. Otherwise, the rule applies from the **first day of the fifth quarter following the date on which the BHC becomes a Covered Company**.	Rule applies from **October 1, 2013**, for companies that are designated before September 30, 2012. Otherwise, the rule applies from the **first day of the fifth quarter following the date a company is designated**.
Supervisory Stress Testing Requirements	Rule applies on the **effective date**. Rule applies from **September 30 of the year in which a BHC becomes a Covered Company**, if the BHC became a Covered Company at least 90 days before September 30 of that year.	Rule applies from **September 30 of the year in which a company is designated**, if the company was designated at least 180 days before September 30 of that year.

Proposed Rule Requirements	Bank Holding Companies	Designated Non-Bank SIFIs
Company-Run Stress Testing Requirements[1]	Rule applies on the **effective date**. Rule applies from **September 30 of the year in which a BHC becomes a Covered Company or reaches $10 billion in total consolidated assets**, if the BHC became a Covered Company or reached more than $10 billion in total consolidated assets at least 90 days before September 30 of that year. If a BHC becomes a Covered Company at least 90 days before March 31 of a calendar year, the rule applies from **March 31 of that year**.	Rule applies from **September 30 of the year in which** a company is designated, if the company was designated at least 180 days before September 30 of that year. If the company is designated at least 180 days before March 31 of a calendar year, the rule applies from **March 31 of that year**.
Debt-to-Equity Limits for Certain Covered Companies	Appears to be effective immediately. A Covered Company will have **180 days to comply** (with possible extensions) after receiving notice from the FSOC that it has made a determination that the Covered Company poses a grave threat to the financial stability of the United States.	Appears to be effective immediately. A Covered Company will have **180 days to comply** (with possible extensions) after receiving notice from the FSOC that it has made a determination that the Covered Company poses a grave threat to the financial stability of the United States.
Liquidity Requirements; Risk Management and Risk Committee Requirements; and Early Remediation Framework	Rules apply from the **first day of the fifth quarter following the effective date**. For BHCs that become Covered Companies after the effective date, the rules apply from the **first day of the fifth quarter following the date on which the BHC became a Covered Company**.	Rules apply from the **first day of the fifth quarter following the effective date**. For companies that are designated after the effective date, the rules apply from the **first day of the fifth quarter following the date of designation**.

[1] State member banks and SLHCs with more than $10 billion in total consolidated assets will also be subject to company-run stress testing requirements, on the same schedule as BHCs with more than $10 billion in total consolidated assets, except that the rule will only apply to SLHCs once SLHCs are subject to minimum risk-based capital and leverage requirements.