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Alert Memo

JANUARY 24, 2012

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The Federal Reserve Board's Heightened Prudential Requirements for Systemically Important Financial Institutions: Initial Framework, but More Detail to Follow

In a long-awaited proposal that many consider is the heart of Dodd-Frank Act regulation, entitled "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,"[1] the Federal Reserve provides the initial architecture for the imposition of "more stringent" supervision and prudential standards on systemically important financial institutions. 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. Financial institutions should anticipate that the Federal Reserve will not only add to this initial construct through the items that it specifically identified for future rule-making, but likely also will revise the rules over time as the Federal Reserve gains experience with coordinating the various pieces of their framework and applying the framework to large bank holding companies and non-bank financial companies.

As might be expected for a proposal that leaves many details to future rule-making, the Federal Reserve would rely significantly on centralized corporate governance requirements as a key tool to enforce a heightened awareness of the more stringent requirements under the proposal. Although not unique to this proposal, institutions subject to the proposal should recognize that the Federal Reserve's framework will require alterations and enhancements to not only the substance of what is produced for the regulators, but also to internal processes for achieving, monitoring and escalating compliance with the substantive requirements. Elevating corporate governance standards to the level of regulation also may lead regulators to second-guess business judgments of a company's board of directors or senior management and cite process weaknesses as violations of regulatory mandates.

The Federal Reserve's proposal did include two sets of significant and substantive rules: single counterparty credit limits and an early remediation framework. The key question under the credit limit rules will be whether the methodology used for

[1] 77 Fed. Reg. 594 (Jan. 5, 2012) (the "Proposed Rule"). The Proposed Rule implements portions of Section 165 and Section 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

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calculating the exposure to counterparties under a variety of transactions is sufficiently consistent with risk management tools currently used by the industry (which were significantly enhanced during and after the recent crisis). Under the early remediation framework, the Federal Reserve has proposed mandatory restrictions, activity limitations and potential management changes for institutions that evidence a deteriorating financial condition or weaknesses in compliance with prudential standards. A critical issue will be whether some of the more subjective and qualitative triggers will provide sufficient predictability for a stressed institution.

Helpfully, the proposal integrates, builds on, and attempts 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. As a result, however, the proposal 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 an outline summary of the proposal, and identifies and discusses the key issues that it raises. To facilitate review, we have highlighted the areas in our outline where we focus on such key implications and observations.

The Federal Reserve has requested comments by March 31, 2012.

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I. SCOPE

A. Covered Companies

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

   (a) All bank holding companies ("BHCs") with total consolidated assets equal to or greater than $50 billion.

      (i) A U.S. BHC would meet this requirement if the average of its total consolidated assets reported on i ts four most recent quarterly reports on FR Y-9C were greater than $50 billion.

      (ii) A BHC would cease to be covered by the enhanced rules if its total consolidated assets were to fall, and remain, below $50 billion for each of four consecutive quarters.

   (b) 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").

2. The Federal Reserve would generally apply the same standards to the Non-Bank SIFIs as it would to the covered BHCs, although the Federal Reserve noted that it would have discretion to tailor the application of the rules based on the attributes of individual companies or a category of companies.

The application of capital and related rules to non-bank financial institutions has historically proven challenging. For example, subsequent to the implementation of the Gramm-Leach-Bliley Act, as insurance companies acquired banks and BHCs acquired insurance companies, imposing capital requirements on insurance companies created difficulties because of the different array of risks encountered by insurance companies. Ideally the Federal Reserve would use this flexible "tailoring" authority to avoid such difficulties. However, the key challenge will be to create some level of consistency in application so as to not be seen as "favoring" an institution or industry.

To date, the FSOC has not designated any companies as Non-Bank SIFIs. As a result, non-bank financial companies may have difficulties preparing for compliance with, and commenting on, this proposal.

Covered Companies likely will want to seek clarity on how the proposal's requirements would apply throughout their organizations. Some of the provisions are relatively clear, such as the single-counterparty credit limits that apply to the aggregate net exposure of a Covered Company and all its subsidiaries to a counterparty. However, other rules, such as the capital planning, stress testing

and risk management requirements, focus primarily on compliance by the "Covered Company", but do not sufficiently clarify whether subsidiaries (or at least material subsidiaries) should also be undertaking similar compliance actions on a separate, stand-alone basis.

B. Foreign Banking Organizations

1. The proposal does not include a framework applicable to foreign banking organizations ("FBOs") that would otherwise be Covered Companies, but the Federal Reserve stated that it will issue "shortly" a separate proposal on the application of heightened standards to FBOs. Accordingly, the use of the term "Covered Company" in this memorandum does not include an FBO.

2. The proposal would, however, apply to any U.S.-based BHC subsidiary of an FBO that meets the applicable thresholds. Intermediate U.S. BHC subsidiaries of FBOs that rely on Federal Reserve SR Letter 01-01 (as in effect on May 19, 2010)[1] would generally be exempt from all requirements other than the proposed liquidity, risk management and debt-to-equity limit provisions until July 21, 2015.

C. Foreign Non-Bank SIFIs

1. The Proposed Rule defines a Non-Bank SIFI as "any company organized under the laws of the United States or any State" that is designated as systemically important by the FSOC.

2. Although a foreign non-bank financial company can be designated as a Non-Bank SIFI by the FSOC pursuant to Section 113(b) of the Dodd-Frank Act, only its U.S. activities and subsidiaries are to be covered by the heightened standards, pursuant to Section 102(c) of the Dodd-Frank Act, and only its financial activities are to be subject to Federal Reserve supervision, pursuant to Section 113(c)(6) of the Dodd-Frank Act.

3. Although the Federal Reserve indicated that it would issue a future proposal for application of the heightened prudential standards to FBOs, it is not clear whether that future proposal will clarify the application of the framework to foreign Non-Bank SIFIs, or whether the limitation on the definition in this proposal to only companies organized in the United States is meant to provide sufficient clarity to foreign Non-Bank SIFIs.

4. It would seem that difficulties similar to those that the Federal Reserve is encountering with the application of the heightened standards to FBOs would be

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[1] Federal Reserve Supervision and Regulation Letter SR 01-01 (Jan. 5, 2001) (exempting from the Federal Reserve's capital adequacy guidelines the intermediate U.S. BHCs of FBOs that are financial holding companies and that maintain a branch or agency in the United States, i.e., allowing these intermediate BHCs to rely on the parent FBO's capital) ("Federal Reserve SR Letter 01-01").

present in the case of foreign Non-Bank SIFIs as well, particularly if the rules would apply only to their U.S. activities and subsidiaries. For example, will the potential for lending from an overseas head office be recognized as available credit for liquidity planning purposes by the U.S. operations? Can counterparty credit exposure of U.S. operations be hedged through derivatives with affiliated eligible protection providers outside the U.S.? Will foreign Non-Bank SIFIs be required to create a U.S. holding company in order to provide better understanding of the consolidated capital position of the U.S. operations?

D. Savings and Loan Holding Companies

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

   (a) Apply the company-run stress testing requirements of the Proposed Rule to SLHCs with over $10 billion in total consolidated assets; and

   (b) Issue, at a future date, a proposal to apply the enhanced standards to large SLHCs with "substantial banking activities".

   The Federal Reserve describes a potential definition of "substantial banking activities" to include an SLHC that (A) has total consolidated assets of $50 billion or more, and (B) has savings association subsidiaries that comprise 25% or more of the SLHC's total consolidated assets or has at least one savings association subsidiary with total consolidated assets of $50 billion or more.

2. In each case, however, the Federal Reserve would not apply the enhanced standards to SLHCs until it has also established risk-based capital requirements for SLHCs.

E. Certain Requirements Applicable to Other Institutions

1. Annual company-run stress testing requirements would apply to all financial companies with greater than $10 billion in total consolidated assets that are regulated by the Federal Reserve (including state member banks, BHCs and SLHCs).[2]

2. Risk committee requirements would also apply to publicly traded BHCs with $10 billion or more in total consolidated assets.

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[2] This section also applies to such financial companies that are regulated by a "primary federal financial regulatory agency", which includes not only federal bank regulators, but also the Securities and Exchange Commission (the "SEC"), the Commodities and Futures Trading Commission, the Federal Housing Finance Agency (the "FHFA"), and State insurance authorities. Dodd-Frank Act, § 2(12).

F. **Reservation of Authority.** The Federal Reserve notes that it would retain discretion to apply heightened standards to other BHCs and entities under its jurisdiction. In addition, it notes throughout the proposal that it would reserve the right to subject Covered Companies to additional prudential standards not described in the Proposed Rule.

G. **Timing of Applicability.** Appendix A 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.

H. **Other Prudential Standards not Included in this Rule**

1. The Federal Reserve opted not to propose regulations regarding certain prudential standards that were authorized, but not required, by the Dodd-Frank Act, including standards for contingent capital, public disclosure and short-term debt limits.

2. The Federal Reserve did not hint as to whether such rules might be forthcoming, stating only that it "continues to consider whether adopting any of these standards would be appropriate." Although the Federal Reserve attempts, through this rule-making, to integrate and harmonize a number of broad supervisory tools, a piecemeal issuance of further capital and debt limits may be difficult and costly for Covered Companies to implement later.

I. **Future Rule Proposals**. As indicated, the proposal provides the initial framework for a broad set of heightened standards applicable to Covered Companies (and certain other institutions), but leaves significant detail for future rule-making. Appendix B sets forth a general list of those items that the Federal Reserve identified as the subject of future proposals.

II. SINGLE-COUNTERPARTY CREDIT LIMITS

A. Overview

1. The Proposed Rule would require all Covered Companies[3] to adhere to certain aggregate net credit exposure limits with respect to any single counterparty. Prior to the Dodd-Frank Act, banks, but not their BHC parents, were generally subject to legal lending limits—limits on loans to one borrower. Other types of regulated financial institutions may also be subject to similar requirements. Under this proposal, the Covered Company and all of its controlled subsidiaries would be required to observe the new aggregate limits.

   It is unclear whether the regulatory agencies will seek to harmonize credit exposure calculations across multiple disparate regulations. Whether the industry

[3] The Proposed Rule would exempt from the definition of Covered Company any Federal Home Loan Bank ("FHLB") for the purposes of this subpart.

believes such harmonization would be in its best interest is highly dependent upon the resulting impact of each particular regulation. A question left to future rule-making is whether the Federal Reserve and the Office of the Comptroller of the Currency ("OCC") will adopt similar methodologies for revisions to the affiliate transaction and the bank legal lending limit rules, respectively, as mandated by the Dodd-Frank Act.

Another key question will be whether certain economically similar transactions would be treated differently under the credit exposure calculations, potentially adding to the complexity of calculation and advantaging or disadvantaging certain transaction types. For example, some forms of derivative transactions may function similarly to loans or repurchase transactions, but their credit exposure calculations would be different.

Also, in the preamble the Federal Reserve recognizes that subsidiaries of Covered Companies may be subject to other legal lending limits and investment limits, but states its belief that a Covered Company "should" be able to comply with the consolidated credit limit of the Proposed Rule as well as the other limit requirements at subsidiary institutions. Yet the Federal Reserve also requests comment on the interaction with existing limits and any potential "conflicts" in implementation. Commenting may prove difficult at this stage because the OCC is also expected to revise its legal lending limit standards because of changes to those rules mandated by Section 610 of the Dodd-Frank Act. Also, below we discuss a few differences between the Federal Reserve's credit limit proposal and the OCC's legal lending limit rules.

(a) Aggregate net credit exposure is defined as the sum of all net credit exposures of a Covered Company (including exposures of all entities controlled directly or indirectly by the Covered Company) to a single counterparty.

(i) A Covered Company would first calculate its gross credit exposure resulting from credit transactions defined in the Proposed Rule.

(ii) The Proposed Rule then provides for netting, in some cases only for specific credit transactions and in other cases for all credit transactions, in order to determine a Covered Company's net credit exposure.

(b) The "general limit" prohibits a Covered Company from having an aggregate net credit exposure to any unaffiliated counterparty in excess of 25% of the Covered Company's consolidated capital and surplus.[4]

[4] Capital stock and surplus for BHCs is defined as the sum of the entity's total capital, as calculated in accordance with the Federal Reserve's Regulation Y, and the allowance for loan and lease losses not included in Tier 2 capital. Non-Bank SIFIs would calculate their capital stock and surplus in accordance with capital adequacy guidelines to be established by the Federal Reserve.

Especially for the larger Covered Companies, the general limit would be a sizable amount.[5] While it may seem unlikely that a Covered Company would have credit exposure to a single counterparty greater than limits of that magnitude, this is one of the reasons why the treatment of exposure through derivatives and the calculation of net exposure will be so important, as described below in Part II.D. The larger Covered Companies are likely to be significant dealers with securities inventory, and are likely to make up a significant portion of the derivative dealer market. These activities and asset classes have not previously been subject to a credit exposure limit of the type in the Proposed Rule, and the limits may prove to be meaningful constraints on interaction with certain large counterparties that typically can only be served by the largest institutions.

(c) The "major covered company limit"[6] prohibits a Covered Company with more than $500 billion in total consolidated assets from having an aggregate net exposure in excess of 10% of the Covered Company's consolidated capital and surplus to any (i) BHC or FBO with more than $500 billion in total consolidated assets or (ii) Non-Bank SIFI.

Currently there are only 7 BHCs and approximately 38 FBOs with assets greater than $500 billion. The FSOC has not yet designated any Non-Bank SIFIs.

The proposal would apply this more stringent 10% limit to exposures by a very large Covered Company to a very large BHC or FBO. However, it would also apply this more narrow limit to any exposure of a very large Covered Company to a Non-Bank SIFI of any size. The FSOC has signaled that a Non-Bank SIFI likely would have greater than $50 billion in assets and would have to meet other criteria, although smaller entities are not protected by any form of "safe harbor."[7] If non-bank SIFIs with assets between $50 billion and $500 billion are designated by the FSOC, then there could be significant disparity between the limits applicable to large BHCs or FBOs, on one hand, and Non-Bank SIFIs, on the other hand. It is plausible that the Federal Reserve could increase the threshold

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[5] The general limits for the 10 largest top-tier BHCs, which have total consolidated assets of between approximately $320 billion and $2.3 trillion, would be in the approximate range of $4 billion to $58 billion. (These numbers were calculated using the FR Y-9C forms dated September 30, 2011 filed with the Federal Reserve by the 10 largest top-tier BHCs.)

[6] The "major covered company limit" is not required by the Dodd-Frank Act, although the Dodd-Frank Act gave the Federal Reserve statutory authority to impose more restrictive limitations.

[7] See Derek M. Bush & Shara M. Chang, FSOC Reproposes the Nonbank SIFI Designation Rule: A Revised Procedure, but No Greater Clarity Regarding Who Will Be Designated or When, 43 Sec. Regulation & Law Report 2551 (Dec. 19, 2011).

for Non-Bank SIFIs as experience with such entities develops. Although it would appear less likely, the Federal Reserve could also address such a disparity by reducing the size of BHC and FBO counterparties subject to the narrower limit, based on the trend of FSOC designations. The Federal Reserve is seeking comment on potential alternative approaches.

Further, the interdealer market for derivatives, securities, repurchase transactions and securities loan transactions is quite important to the liquidity of the broader market. Notwithstanding the size of the limit for the major covered companies (in an approximate range of $4 billion to $23 billion),[8] the major covered company limit represents a significant decrease from the general limit and could have a detrimental effect on the interdealer market. There would be significant impetus for diversification (with potential opportunities for smaller organizations), but there would also be potential for dislocation in liquidity as other market participants attempted to fill the gaps. In addition, although the application of the limit could result in a reduction of connections between the largest dealers, it could increase overall "interconnectedness" as material relationships with other dealers grow.

2. The credit limit framework would apply to Covered Companies in accordance with the time frames set forth in Appendix A.

3. Compliance

(a) A Covered Company would calculate its aggregate net credit exposure, and comply with the limits, on a daily basis at the end of each business day.

(b) The Covered Company would be required to submit a report on a monthly basis that demonstrates its daily compliance.

(c) The Federal Reserve would stay for 90 days[9] any enforcement action against a Covered Company that is not in compliance with respect to a particular counterparty as a result of certain circumstances, so long as the Covered Company uses reasonable efforts to return to compliance. These circumstances would include:

(i) A decrease in the Covered Company's capital stock and surplus;

(ii) The merger of the Covered Company with another Covered Company;

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8 These numbers were calculated using the FR Y-9C forms dated September 30, 2011 filed with the Federal Reserve by the 10 largest top-tier BHCs.

9 The Federal Reserve may permit non-compliance for other periods of time if appropriate to preserve the safety and soundness of the Covered Company or U.S. financial stability.

(iii) The merger of two unaffiliated counterparties; and

(iv) Any other circumstance deemed appropriate by the Federal Reserve.

The Federal Reserve's proposed compliance and grace period provisions contemplate some, but not all, of the circumstances in which a Covered Company may find its credit exposure to a counterparty increased inadvertently beyond permissible limits. For example, the Proposed Rule does not address a Covered Company's acquisition of assets in satisfaction of a debt previously contracted ("DPC"). To the extent that a Covered Company were to receive DPC assets consisting of debt or equity interests in the obligor to which the Covered Company had the original exposure, the Covered Company would merely be substituting exposure that should already be within limits. However, if DPC assets acquired from one obligor were to create exposure to another obligor (such as through a foreclosure on third party collateral posted by an obligor), a Covered Company could find itself temporarily out of compliance with its exposure limits as it sought to dispose of such assets in a safe and sound manner. Presumably, the exposure acquired through DPC should be excluded from the net credit exposure limit or subject to a generous grace period, but the Proposed Rule does not address the question.

During the non-compliance period, the Covered Company would not be permitted to enter into additional credit transactions with the counterparty, except with Federal Reserve consent. During this time, the Federal Reserve would have the authority to impose additional supervisory oversight and reporting measures necessary to monitor compliance.

4. Future Potential Rule-Makings. The Federal Reserve notes in the preamble that the Basel Committee has established a working group to look into large exposure rules across jurisdictions. This may lead the Federal Reserve to revise its proposal to align with any international agreement on large exposure limits.

B. Scope

1. The Proposed Rule applies to a Covered Company and its subsidiaries (as discussed further, below).

2. Aggregate credit exposure is calculated by a Covered Company with respect to a "counterparty", which is defined to include:

(a) Individuals, and members of their immediate family;

(b) A company and all of its subsidiaries;

(c) The United States (including its agencies and instrumentalities);

(d) Any U.S. state or territory (including its agencies, instrumentalities and political subdivisions); and

(e) Any foreign sovereign entity (including its agencies, instrumentalities and political subdivisions).

In the preamble, the Federal Reserve defends its decision to include U.S. and foreign governmental entities in the "counterparty" definition, notwithstanding that the Dodd-Frank Act required limits on exposure to any unaffiliated "company".

With regard to exposure to State governments and sovereigns, the proposal fails to differentiate between the sovereign and its political subdivisions. The proposal would require exposure to be calculated collectively including all subdivisions. OCC rules typically would apply a more sophisticated "means and purpose" test to determine whether a political subdivision is, in fact, supported by another government body, thus requiring an aggregation of exposure to both; if it is not so supported, then the political subdivision may be considered as a separate counterparty.[10]

The Federal Reserve also seeks comment on how to treat certain SPV counterparties, noting that looking to the underlying assets of a SPV or to its sponsor may, in some cases, provide a more appropriate picture of credit exposure.[11]

3. The status of a company as a "subsidiary" is an important concept in the credit limit rules. A Covered Company must aggregate all of its and its subsidiaries' exposures to a counterparty and all of the counterparty's subsidiaries to determine compliance with the limits. A subsidiary of either a Covered Company or a counterparty is any company that is controlled, directly or indirectly, by the Covered Company or counterparty, respectively. An entity controls another entity if it:

(a) Owns, controls, or holds with the power to vote 25% or more of a class of voting securities of the entity;

(b) Owns or controls 25% or more of the total equity of the entity; or

(c) Consolidates the entity for financial reporting purposes.

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10 See 12 C.F.R. § 32.5(f).

11 The OCC has issued some interpretations related to exposures to entities holding pooled loans. See OCC Interpretive Letter No. 579 (Mar. 24, 1992) (concluding, for purposes of lending limits, that a bank's ownership of senior certificates in a pool of loans would be considered a loan to the originator/seller/servicer of loans to the pool); see also OCC Interpretive Letter No. 1035 (July 21, 2005) (stating generally that investment securities limits under OCC's Part 1 rules for pooled loans are designed to limit exposure to the originator/servicer of loans).

On one hand, these more objective tests should be easier in practice to apply to a counterparty than attempting to apply the Federal Reserve's "controlling influence" standard or the OCC's common enterprise and financial interdependence tests. On the other hand, 25% of a company's voting securities or equity is generally not a control standard recognized in non-banking industries, and counterparties might be surprised to find that their ability to obtain credit has been curtailed by credit supplied by a Covered Company to entities that the counterparty does not consolidate and does not consider controlled. In addition, the 25% threshold is much lower than that usually required to satisfy GAAP consolidation, which then contrasts significantly with the third test that the Federal Reserve employs in the proposal. Further, Non-bank SIFIs not familiar with implementing this 25% standard may require significant structural reviews and more robust aggregation methodologies in order to achieve compliance with the aggregate limits.

The control definition also contrasts with the Federal Reserve's September 2008 policy statement on control, which clearly indicated that there are circumstances where 33% of a company's total equity could be acquired before control would be found.[12]

The Federal Reserve is seeking comment on whether funds or other similar vehicles that are sponsored or advised by a Covered Company should be aggregated with the exposures of the Covered Company. The preamble notes that some institutions had provided support for such vehicles during the recent crisis and had purchased assets out of such vehicles to improve liquidity and satisfy investor redemptions. In some ways this question is similar to the Federal Reserve's expectation in the liquidity management provisions (discussed below) that Covered Companies should anticipate liquidity outflows to funds or other vehicles, even if not legally required, that may be designed to mitigate reputational risk. However, anticipating that a Covered Company might provide liquidity to such a vehicle would seem to be significantly different from treating the vehicle as if its holdings were aggregated with those of the Covered Company. Including the exposures of such entities without evidence of any contractual requirement to support or consolidate the entity would seem to erode definitions of control and the meaning of the sponsored/advised relationship.

4. "Credit transaction" means any extension of credit to a counterparty, including loans, deposits, and lines of credit[13]; repurchase and reverse repurchase agreements; securities lending and borrowing transactions; guarantees, acceptances and letters of credit; purchases and investments in securities issued by a counterparty; and derivative transactions (including credit and equity derivative transactions based on a security issued by the counterparty) that create

[12] Federal Reserve Policy Statement on Equity Investments in Banks and Bank Holding Companies (Sept. 22, 2008).

[13] The definition excludes advised or uncommitted lines of credit.

a credit exposure to a counterparty. The definition also includes transactions that are functionally equivalent to the enumerated transactions, as well as "any similar transaction that the [Federal Reserve] determines to be a credit transaction".

The Dodd-Frank Act included deposits as a form of extension of credit under Section 165(e)(3)(A), and the Federal Reserve's rule is consistent with the statute. Yet, OCC precedent generally excludes deposits at other banks from the legal lending limits.[14] Notably, Congress did not explicitly include deposits in the revisions to the national bank legal lending limits in Section 610 of the Dodd-Frank Act.

Section 165(e)(3)(D) of the Dodd-Frank Act defines credit exposure to include "all purchases of or investment in securities issued by" a counterparty. The statute is focused significantly on "credit" risks. Nevertheless, the Federal Reserve used its discretion to interpret credit exposure to include the ownership of equity securities of a counterparty. This seems to be consistent with the Federal Reserve's expressed belief after the recent crisis that institutions should understand their "total exposure" and all touch points with another institution. Nonetheless, it adds a new element to credit risk management that may not be familiar to industry credit managers.

C. <u>Calculation of Credit Exposure for Credit Transactions</u>

The Proposed Rule sets forth how a Covered Company is required to calculate its gross credit exposure with respect to certain credit transactions, and then mechanisms for reducing that exposure to a net credit exposure. There are specific netting mechanisms with respect to some credit transactions and additional netting mechanisms that apply to credit transactions generally.

The Federal Reserve is also seeking comment on whether a supplemental, gross credit exposure limit may be appropriate.

A key question will be whether the Federal Reserve's methodologies for calculating credit exposure 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.

1. <u>Loans and Leases</u>. The gross credit exposure for loans and leases is equal to the amount owed by the counterparty to the Covered Company.

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[14] <u>See</u>, <u>e.g.</u>, OCC Unpublished Interpretive Letter (Mar. 4, 1983).

It is not clear whether the "amount owed" under an extension of credit would include accrued interest, which is exempt under existing OCC rules.[15]

2. Lines of Credit or Revolving Credit Facilities

(a) The gross credit exposure with respect to a committed line of credit is equal to the full face amount of the credit line.

(b) Net Credit Exposure. A Covered Company may reduce its gross credit exposure by the amount of the unused portion of the credit line or revolving credit facility if the Covered Company is not legally obliged to advance additional funds until the counterparty provides an amount of adjusted market value of collateral[16] sufficient to secure the full drawn amount under the credit line.[17]

3. Guarantees and Letters of Credit. The gross credit exposure for guarantees and letters of credit issued by a Covered Company on behalf of a counterparty is equal to the lesser of (i) the face amount or (ii) the maximum potential loss to the Covered Company.

4. Debt Securities. The gross credit exposure for debt securities equals the greater of the amortized purchase price or market value, with respect to securities held as "for trading" or "available for sale", or, with respect to securities held to maturity, the amortized purchase price.

5. Equity Securities. The gross credit exposure for equity securities equals the greater of the purchase price or market value.

6. Repurchase and Reverse Repurchase Agreements

(a) The gross credit exposure for repurchase agreements is equal to the sum of (i) the market value of the transferred securities and (ii) the market value multiplied by the applicable collateral haircut set forth in Table 2 of the Proposed Rule.[18] For reverse repurchase agreements, the gross credit

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15 See 12 C.F.R. § 32.2(k)(2)(ii).

16 For this provision only, the types of permitted collateral are limited to cash, obligations of the United States and its agencies, obligations fully guaranteed by the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac"), and other U.S. GSE -issued obligations as determined by the Federal Reserve.

17 This exemption for unused portions of credit lines is similar to the Federal Reserve's exemption under Section 23A rules for unused portions of credit lines from a bank to one of its affiliates. See 12 C.F.R. § 223.14(f)(2).

18 The collateral haircuts are similar to those under the Federal Reserve's capital adequacy rules. See 12 C.F.R. Part 225, App. G, Part IV, Table 3 - Standard Supervisory Price Volatility Haircuts. Notwithstanding the similarity with the capital rules, the proposed haircuts may not be consistent with market practice or negotiated transactions. This could lead to potential

exposure is the amount of cash transferred by the Covered Company to the counterparty.

(b) Net Credit Exposure. If subject to a bilateral netting agreement, the net credit exposure is equal to the net credit exposure under that netting agreement. In addition, the net credit exposure for securities financing transactions may be further adjusted pursuant to the market value adjustments discussed below.

7. Securities Lending and Borrowing

(a) The gross credit exposure for securities borrowing transactions is equal to the sum of (i) the amount of cash and (ii) the market value of securities collateral transferred by the Covered Company to the counterparty. For securities lending transactions, gross credit exposure is equal to the sum of (i) the market value of securities lent and (ii) the market value multiplied by the applicable collateral haircut set forth in Table 2 of the Proposed Rule.

(b) Net Credit Exposure. If subject to a bilateral netting agreement,[19] the net credit exposure is equal to the net credit exposure under that netting agreement. In addition, the net credit exposure for securities financing transactions may be further adjusted pursuant to the market value adjustments discussed below.

8. Derivative Transactions

(a) Derivative transactions not subject to a qualifying master netting agreement.[20]

The gross credit exposure is equal to the sum of (i) the current exposure of the contract equal to the greater of its mark-to-market value or zero and (ii) its potential future exposure, which is calculated by multiplying the

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mismatches (or larger mismatches than would exist already) between the credit exposure calculation and any collateral received by a Covered Company.

[19] The Proposed Rule does not define "bilateral netting agreement" for purposes of the repurchase/reverse repurchase and securities lending/borrowing provisions or clarify how such netting calculations are to be performed. Cf. OCC Interpretive Letter No. 1088 (Sept. 11, 2007) (concluding, for purposes of the OCC lending limits, that repurchase and reverse repurchase agreements subject to a netting agreement with a single counterparty would be subjected to the limits by (i) netting cash advanced and cash received for all contracts maturing on the same day, (ii) totaling the individual daily net obligations for days where the counterparty owed the bank a net amount, but (iii) excluding completely (i.e., not netting) those days where the bank owes the counterparty a net obligation).

[20] The definition of "qualifying master netting agreement" is the same as that under the capital adequacy guidelines. 12 C.F.R. Part 225, App. G, § 2.

contract's notional principal amount by a conversion factor set forth in Table 1 of the Proposed Rule.

(b) Derivative transactions subject to a qualifying master netting agreement.

The gross credit exposure is equal to the exposure at default amount calculated pursuant to the Federal Reserve's capital rules.[21]

(c) Credit and equity derivative transactions where the Covered Company is the protection provider and the reference asset of which is an obligation or equity security of the counterparty.

The gross credit exposure is treated similarly to a guarantee and is equal to the lesser of (i) the face amount of the transaction or (ii) the maximum potential loss to the Covered Company.

The preamble states that a Covered Company's exposure to a derivative counterparty will also include any initial margin and excess variation margin posted to the counterparty, unless the margin is held in a segregated account at a third party custodian. However, the text of the Proposed Rule does not address this issue. Although the logic of the concept is understandable, it should be noted that initial margin payments to central and bilateral counterparties likely will be required pursuant to rules promulgated under Title VII of the Dodd-Frank Act and possible analogous non-U.S. rules.

The text of the Proposed Rule also does not address the statements in the preamble requiring a Covered Company's guarantee fund contribution to a central counterparty to be included in the exposure to the central counterparty. Certain derivatives are mandated to be centrally cleared pursuant to Title VII of the Dodd-Frank Act and analogous non-U.S. rules. As the clearing of derivatives becomes more commonplace pursuant to such requirements, derivative dealers will likely need additional flexibility in their limits to clearinghouses and exchanges. It was anticipated that the Federal Reserve could potentially address exposure to central counterparties separately. The Proposed Rule does not include any such discussion, but the Federal Reserve does ask for comment on the issue as a public policy concern.

The preamble and the Proposed Rule make it clear that entrance into credit and equity derivatives where a Covered Company is responsible for downside risk on the reference asset results in two types of exposure—credit exposure to the derivative counterparty and exposure to the reference asset. In a simple single-name credit default swap where the Covered Company is the protection provider, there would not typically be exposure to the counterparty because derivative payments, other than fees, are made only by the protection seller. However, in a total return swap, a Covered Company could provide downside

[21] 12 C.F.R. Part 225, App. G, § 32(c)(6).

protection, but receive upside benefits from the counterparty, and therefore would have exposure to the counterparty as well as to the reference asset.

9. Attribution Rule

The Proposed Rule requires that, to the extent that the proceeds of a credit transaction with a third-party are "for the benefit of, or transferred to" a counterparty, the credit transaction be treated as credit exposure to that counterparty.

Although the Federal Reserve stated that it would propose to "minimize the scope" of the attribution rule because it could lead to "inappropriate results" and a "daunting" tracking exercise, no explanation of how it would be minimized is included in this proposal. The attribution concept stems in part from Section 23A bank-affiliate rules about transactions with third parties that may be deemed transactions between the bank and its affiliate. However, in the 23A context, practically speaking, a bank could establish some internal methods of understanding whether the proceeds or benefits of a transaction came back to an affiliate. In contrast, there would seem to be extreme practical difficulty in determining whether the proceeds or benefits of a third party transaction were received by another third party resulting in a required addition to a Covered Company's exposure to that other third party. If an attribution rule concept is retained in the eventual final rule, it would appear that it would need to be limited to situations in which the Covered Company knowingly extended credit to one party to benefit another party.[22]

D. Other Adjustments to the Calculation of Net Credit Exposure

The Proposed Rule provides for additional adjustments that would apply to any credit transaction. While certain of these adjustments may be made at the Covered Company's option, others are mandatory.

1. Market Value Adjustments. A Covered Company would be permitted, but not required, to reduce its gross credit exposure under any credit transaction by the adjusted market value of any eligible collateral. Eligible collateral includes cash on deposit, bank-eligible investment securities (other than mortgage- or asset-backed securities) and publicly traded equity or convertible debt securities in which the Covered Company has a first priority perfected security interest. A Covered Company using this netting provision would be required to:

[22] Although OCC lending limit rules have a similar attribution concept if the proceeds are used for the "direct benefit" of a third party, the rules contain an exclusion for "bona fide arm's-length" transactions for the acquisition of property, goods or services. See 12 C.F.R.§ 32.5(b).

(a) Include the adjusted market value of the eligible collateral in its calculation of gross credit exposure to the issuer of the collateral;[23] and

(b) Not use the collateral used to reduce its exposure to one counterparty to reduce its exposure to another counterparty.

If a Covered Company chooses to use this netting provision, the gross credit exposure to the issuer of collateral for this single transaction would not be deemed to be greater than the credit exposure under the transaction to the counterparty, even if the amount of collateral is greater than the credit exposure created by the transaction to the counterparty.

Although the Federal Reserve stated in the preamble that the list of "eligible collateral" is "similar" to that in the Federal Reserve's Basel II capital rules, the definition is not the same as "financial collateral" under those rules [24] The capital rules would include asset-backed and mortgage-backed securities, gold bullion, certain long-term debt securities that are one notch below investment grade, money market mutual fund shares that are quoted daily and conforming residential mortgages, in addition to the cash and instruments permitted under the Federal Reserve's proposed credit limit rules. Requiring Covered Companies to apply two different collateral and calculation systems to the analysis of the same transactions would seem burdensome and unwarranted.

Although direct exposure to Fannie Mae and Freddie Mac guaranteed obligations is exempt (as discussed below), the ability of a Covered Company to receive Fannie Mae and Freddie Mac guaranteed mortgage-backed securities as exemptive collateral is unclear. B ased on the Federal Reserve's calculation methodology, a credit exposure must first be offset against "eligible collateral" before determining whether the exposure to the collateral (such as to U.S. treasuries) creates an exempt exposure. B ecause asset-backed and mortgage-backed securities are not eligible collateral, a Covered Company may not be able to set off the exposure under the market value adjustment rules, even if such securities were guaranteed by Fannie Mae or Freddie Mac.

For repurchase agreements and securities loan agreements where a Covered Company receives cash from the counterparty, the rule would imply that the cash could be set off to reduce the exposure to the counterparty. However, pursuant to the "eligible collateral" definition, the cash would seem to be required to be "on deposit" with the Covered Company or with a custodian on behalf of the Covered Company. Yet, such transactions are often used for short-term financing to other parties. It should be sufficient for set-off purposes that the Covered Company has

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23 The Federal Reserve noted in the preamble that choosing to apply these market value adjustments may create a burdensome collateral tracking exercise.

24 See 12 C.F.R. Part 225, App. G, § 2.

full use of the cash, but clarity around the cash on deposit requirement will need to be sought.

2. Other Eligible Hedges. A Covered Company could also choose to reduce its gross credit exposure under any credit transaction by the face amount of a Covered Company's short sale in a debt or equity security issued by the counterparty.

3. Eligible Guarantees. A Covered Company would be required to reduce its gross credit exposure "by the amount of any eligible guarantees from an eligible protection provider that covers the transaction". The Covered Company is then required to add the amount of such guarantees to its gross credit exposure to the eligible protection provider. If the amount of the eligible guarantee were greater than the amount of the credit transaction being guaranteed, the gross credit exposure to the protection provider is limited to the amount of the credit transaction.

   (a) The Federal Reserve has prescribed extensive specific requirements for a guarantee to be an "eligible guarantee" which are similar to the eligible guarantee concept in the Federal Reserve's capital adequacy guidelines.[25]

   (b) The Proposed Rule sets forth a list of "eligible protection providers".[26]

4. Eligible Credit and Equity Derivatives. A Covered Company would be required to reduce its gross credit exposure "by the notional amount of any eligible credit or equity derivative from an eligible protection provider that references the counterparty". The Covered Company would then add the face amount of such derivatives to its gross credit exposure to the eligible protection provider. If the amount of the eligible derivative were greater than the amount of the credit transaction being guaranteed, the gross credit exposure to the protection provider would be limited to the amount of the credit transaction.

   (a) An "eligible credit derivative" is defined as "a single-name credit derivative or a standard, non-tranched index credit derivative", subject to certain requirements.

   (b) An "eligible equity derivative" is defined as only an equity-linked total return swap, subject to certain requirements.

The ability of a Covered Company to reduce its exposure to a counterparty through the use of eligible credit or equity derivatives contrasts with the Federal Reserve's view under Section 23A and Regulation W rules on ba nk-affiliate

[25] 12 C.F.R. Part 225, App. G, § 2.

[26] The Proposed Rule would include as eligible protection providers sovereign entities, various supra-national and quasi-governmental entities, certain financial institutions, and qualifying central counterparties.

transactions that such credit substitutes or hedges will not reduce amounts that must be counted toward the Section 23A quantitative limits.[27]

Although eligible credit and equity derivatives permit a reduction of exposure to a counterparty, there is no mention of funded participations sold to third parties—such participations would exempt the participated portion from the calculation of exposure under OCC rules.[28]

The Federal Reserve noted in the preamble that "the rule only recognizes simple derivative hedges on a transaction-to-transaction basis. The rule does not accommodate … portfolio hedging". Although there may be practical difficulties in applying these offsets to a more sophisticated trading operation, the Federal Reserve does not explain why Covered Companies would not be permitted to develop a methodology to offset credit exposure created in their derivative or cash trading books with other derivatives in the trading book. The preamble statement also seems inconsistent with the proposal's objective to require eligible credit and equity derivatives to be offset against other credit exposures. Given these inconsistencies, clarity will need to be sought by Covered Companies with derivatives operations to determine the full impact of this requirement.

The preamble uses examples of an eligible credit derivative offsetting exposure created by ownership of bonds, and an eligible equity derivative offsetting exposure created by ownership of equities. Yet the text of the Proposed Rule is not so limited and, seemingly would require any eligible credit or equity derivative to be offset against the gross exposure to an obligor regardless of the source of such aggregate gross exposure.

Eligible equity derivatives would be limited to total return swaps. This limitation would impinge upon a Covered Company's ability to decide the types of derivatives that would provide exposure reduction in a cost-effective manner.

E. Exempted Exposure Categories

1. Certain credit transactions would be exempt from the credit exposure limits:

   (a) Direct claims on, and the portions of claims that are directly and fully guaranteed with respect to principal and interest by:

      (i) The United States and its agencies;

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[27] See, e.g., 67 Fed. Reg. 76,560, 76,588 (Dec. 12, 2002) (the Federal Reserve noting that "[c]onsistent with the [Federal Reserve's] traditional views on hedging under Section 23A, the rule does not allow a member bank to reduce its covered transaction amount for these derivatives to reflect hedging positions established by the bank with third parties").

[28] See 12 C.F.R. § 32.2(k)(2)(vi).

(ii) Fannie Mae and Freddie Mac;[29] and

(iii) Any other obligations issued by a U.S. government-sponsored entity (a "GSE"), as determined by the Federal Reserve.

Transactions secured by such eligible collateral would also be exempt if the Covered Company opted to offset the counterparty credit risk by the amount of collateral.

However, as noted above, the ability to exempt a transaction by taking Fannie Mae and Freddie Mac mortgage-backed securities is unclear. OCC rules also exempt loans secured by general obligations of a State or political subdivision of a state, provided the bank has an opinion of a state legal official that the general obligations are valid and enforceable.[30]

(b) Intraday credit exposure.

(c) Any other transaction that the Federal Reserve exempts. The Federal Reserve must determine that the exemption is in the public interest and consistent with the purpose of the credit exposure limit requirements.

III. RISK-BASED CAPITAL REQUIREMENTS AND LEVERAGE LIMITS

A. Implementation in Two Stages

1. In the first stage of implementation of the proposal, all Covered Companies would become subject to the Federal Reserve's framework for capital regulation as though they were BHCs, including the recently finalized capital planning requirement.

Accordingly, the proposal would not immediately impose any new capital requirements on Covered Companies that are BHCs. However, for Non-Bank SIFIs, the proposal would likely mean a profound transformation of their capital regulation. Most Non-Bank SIFIs are not currently subject to formal consolidated capital and leverage requirements, or may be subject to different capital maintenance requirements (such as insurance company or broker-dealer capital requirements).

(a) The proposal would require a Non-Bank SIFI to meet the following requirements within 180 days of its designation as a Non-Bank SIFI by the FSOC:

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29 The exemption for claims on Fannie Mae and Freddie Mac would be in effect only while those entities are operating under the conservatorship or receivership of the FHFA.

30 See 12 C.F.R. § 32.3(c)(5)(ii)

(i) Comply with the Federal Reserve's recently finalized capital plan rule, which includes an effective requirement to maintain a Tier 1 common risk-based ratio of 5% under expected and stressed conditions,[31] as well as any subsequent regulations adopted by the Federal Reserve relating to capital plans and stress tests;

(ii) Calculate its minimum risk-based and leverage capital requirements as if it were a BHC in accordance with the Federal Reserve's requirements for BHCs. These requirements consist of:

(A) A risk-based capital requirement, which would be calculated under the generally applicable risk-based capital rules (currently "Basel I") or, if the Non-Bank SIFI has total consolidated assets in excess of $250 billion or foreign exposure in excess of $10 billion, under the "Basel II" advanced approaches;

(B) A leverage capital requirement, which keys off on-balance sheet assets; and

(C) A market risk capital requirement, if the Non-Bank SIFI has trading activity equal to $1 billion or 10% or more of its total assets.

(iii) Hold capital sufficient to meet (i) a Tier 1 risk-based capital ratio of 4% and a total risk-based capital ratio of 8%, as calculated according to the Basel I general risk-based rules, and (ii) a Tier 1 leverage ratio of 4%.

While the proposal will subject Non-Bank SIFIs to capital requirements within six months of their designation by the FSOC, it is important to note that Non-Bank SIFIs will only be required to maintain the minimum ratios necessary to be considered "adequately capitalized" as calculated under Basel I. By contrast, most covered BHCs are financial holding companies and therefore must maintain the elevated capital ratios necessary for "well capitalized" status.[32] In addition, while Non-Bank SIFIs that meet

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[31] See 12 C.F.R. § 225.8. 76 Fed. Reg. 74,631 (Dec. 1, 2011). The capital plan rule would not apply to an FBO unless it has a U.S. BHC subsidiary, and consistent with the phase-in period for the imposition of minimum risk-based and leverage capital requirements established by Section 171 of the Dodd-Frank Act, the capital plan rule, like the proposal, will not, until July 21, 2015, apply to any intermediate U.S. BHC of an FBO that is relying on Federal Reserve SR Letter 01-01.

[32] Section 606 of the Dodd-Frank Act amends the Bank Holding Company Act of 1956 to add to the requirements for engaging in financial activities as a financial holding company a specification that the holding company (as well as its subsidiary depository institutions as required under the Gramm-Leach-Bliley Act) be well capitalized and well managed. Currently, under the Federal

the thresholds for the Basel II advanced approaches and the market risk rule must calculate their capital requirements under these regulations, the Proposed Rule would not require them to comply with these rules' minimum capital requirements—including the operational risk capital requirement under the Basel II advanced approaches. However, even though the Proposed Rule would not itself impose binding capital requirements on Non-Bank SIFIs with respect to these particular rules, Non-Bank SIFIs will face a significant burden in developing and implementing the internal models and controls necessary to calculate their capital requirements under these rules and will be required to do so on an accelerated time frame.

(b) A Non-Bank SIFI would be required to report "immediately" any failure to maintain the prescribed risk-based capital and leverage requirements and to report its capital ratios quarterly to the Federal Reserve, although the form of disclosure and whether such reports would be made public is not addressed.

2. To implement the second phase of the proposal's enhanced capital requirements, the Federal Reserve proposes to issue a subsequent rule-making that is expected to include a quantitative, risk-based capital surcharge above the minimum risk-based capital standards that would apply to Covered Companies or a "subset" of Covered Companies.

B. Capital Planning

1. The Proposed Rule would require all Covered Companies to comply with the Federal Reserve's capital plan rule. The capital plan rule imposes the following requirements on companies subject to the rule:

(a) Each Covered Company would be required to develop an annual capital plan and submit such capital plan to the Federal Reserve. The capital plan is expected to include:

(i) An assessment of the expected uses and sources of capital over at least a nine-quarter planning horizon, assuming both expected and stress scenarios;

Reserve's Regulation Y, a BHC is considered "well capitalized" if it maintains a Tier 1 risk-based ratio of 6% and a total risk-based ratio of 10%. See 12 C.F.R. § 225.2(r).
The definitions of well capitalized and adequately capitalized are expected to change in connection with the adoption of final rules implementing Basel III which will increase the minimum capital requirements for banking organizations and will phase-in a formal Tier 1 Common risk-based requirement.

(ii) A description of the Covered Company's process for assessing capital adequacy;

(iii) The Covered Company's capital policy; and

(iv) A discussion of expected changes to a Covered Company's business that are likely to have a material effect on the Covered Company's capital or liquidity adequacy.

(b) The board of directors, or a designated committee of the board of directors, of the Covered Company would be required to review the "robustness" of the process for assessing capital adequacy and approve the capital plan annually.

2. Each Covered Company must demonstrate how it would meet all of the Federal Reserve's minimum risk-based capital ratios, as well as a minimum Tier 1 common to total risk-weighted assets ratio of 5%, under both expected and stress scenarios.

Currently, the Federal Reserve's capital adequacy guidelines for BHCs contain no formal Tier 1 common minimum requirement. Basel III establishes a Tier 1 common risk-based requirement of 7% to be phased in over seven years beginning in 2013. Under the Basel III phase-in, the Tier 1 common requirement will not reach 5% until 2016. However, Covered Companies are required to show they can maintain this level on a pro forma basis in order to be eligible to engage in capital distributions. The rule also provides that this 5% requirement will remain in place until final rules implementing Basel III are adopted by the Federal Reserve. The requirement that Covered Companies must also be able to demonstrate they can maintain this ratio under the stress test assumptions provided by the Federal Reserve suggests that Covered Companies may in fact be subject to a more stringent capital requirement under the capital plan rule than under Basel III on a fully phased-in basis.

3. The Federal Reserve expects that the capital planning requirement would work in tandem with both the supervisory and company-run stress tests that would be required by the Proposed Rule, and that Covered Companies would incorporate the results of the stress tests into their capital plans. The Federal Reserve would consider stress test results in evaluating a Covered Company's capital plan.

4. The capital plan rule also requires significant data submission to the Federal Reserve to enable the Federal Reserve to assess a Covered Company's capital plan.

5. Capital plans would be due by January 5 of each year, and the Federal Reserve would provide feedback on, including objections or non-objections to, each capital plan by March 31 of each year.

6. A Covered Company would be expected to submit changes to a capital plan if the Federal Reserve objected to an original plan, if the Federal Reserve notifies the Covered Company in writing that it is required to resubmit its capital plan, or if the Covered Company determines that there has been or will be a material change to the company profile used in the capital plan.

7. A Covered Company would be prohibited from making capital distributions, even if the capital distributions were described in the capital plan, until the Federal Reserve has indicated its non-objection to the Covered Company's capital plan or to individual capital distributions.

   A "capital distribution" means a redemption or repurchase of any debt or equity capital instrument, a payment of common or preferred stock dividends, a payment that may be temporarily or permanently suspended by the issuer on any instrument that is eligible for inclusion in the numerator of any minimum regulatory capital ratio and any similar transaction that the Federal Reserve determines to be in substance a distribution of capital.[33]

C. Future Capital Rule-Making, Including Capital Surcharge

1. The Federal Reserve plans to issue a future proposal for the application of a quantitative risk-based capital surcharge that would apply to Covered Companies, or a "subset" of Covered Companies, and that would be "based on" the approach established by the Basel Committee on Banking Supervision (the "Basel Committee") in its recent framework for global systemically important banks ("G-SIBs").[34]

   Although the Federal Reserve indicated that the future proposal would seek to finalize implementing rules by 2014 for phase-in from 2016 to 2019, consistent with the Basel Committee's timeline, it did not indicate whether all, or to what extent, Covered Companies may be subject to a surcharge. The Proposed Rule also provides no clarity as to whether the Federal Reserve plans any adjustments to the Basel Committee's G-SIB surcharge approach if the surcharge is applied to a broader group of covered companies than the 8 U.S. BHCs that the Financial Stability Board ("FSB") indicated are expected to be subject to the G-SIB capital surcharge. In recent public statements, Governor Tarullo has indicated that Federal Reserve staff is still evaluating a range of approaches, which could include applying no surcharge to Covered Companies that are not designated as G-SIBs by the FSB or a "Pillar II" approach of company-specific surcharges that would be applied and evaluated as part of the supervisory process. Governor Tarullo also specifically stated that even if surcharges would be applied to Covered BHCs that are not otherwise identified as G-SIBs, their amounts would

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[33] 12 C.F.R. §§ 225.8(c)(3), (c)(4).

[34] See Basel Committee on Banking Supervision, Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement (Nov. 2011), available at http://www.bis.org/publ/bcbs207.htm.

be "quite modest" given the Federal Reserve's analysis of these institutions systemic footprints.[35]

2. Overview of the G-SIB Surcharge

(a) The Basel Committee's G-SIB framework establishes five capital surcharge categories, for the largest, most complex and globally active financial companies, ranging from 1% to 2.5% above the minimum required capital levels set by the Basel III capital accord.

The framework also provides for an additional 1% surcharge (resulting in a potential surcharge of 3.5%) for the largest and most complex G-SIBs to deter them from increasing their systemic importance, although currently no G-SIB would be subject to this punitive requirement.

(b) G-SIBs would be allocated to a surcharge category based on a formula that evaluates twelve factors related to size and complexity of the organization.

(c) The G-SIB surcharge would be phased in from 2016 to 2019.

(d) 29 institutions, including 8 U.S. banking organizations, have been preliminarily identified as potential G-SIBs.[36] However, the FSB and the Basel Committee have indicated that they will not publish a definitive list of G-SIBs that would be subject to the surcharge until 2014.

IV. LIQUIDITY REQUIREMENTS

A. Scope

1. The Federal Reserve would take a multifaceted approach to liquidity management by imposing a liquidity buffer and liquidity stress testing, and coordinating these requirements through a mandatory contingency funding plan and broad corporate governance directives.

2. The Proposed Rule would require that a Covered Company customize every element of its liquidity risk management programs to take into consideration the company's capital structure, risk profile, complexity, activities and size.

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[35] Governor Daniel K. Tarullo, The Evolution of Capital Regulation, Speech before the Clearing House Business Meeting and Conference (Nov. 9, 2011) available at http://federalreserve.gov/newsevents/speech/tarullo20111109a.htm

[36] See Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions (Nov. 4, 2011), available at http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

B. Cash Flow Projections

1. The initial critical element of liquidity risk management would be the development of cash flow projections. The Proposed Rule would require that a Covered Company produce comprehensive cash flow projections for short- and long-term periods. A Covered Company would be required to update its short-term projections daily and its long-term projections at least monthly.

2. The preamble suggests that the cash flow projections should be dynamic analyses that incorporate management's reasoned assumptions regarding the future behavior of assets, liabilities and off-balance sheet items. The preamble also indicates that the Federal Reserve expects senior management periodically to review and approve the assumptions used in the cash flow projections.

C. Liquidity Stress Testing

1. The Proposed Rule would require that a Covered Company stress test its cash flow projections at least monthly, and would require that a Covered Company be able to conduct the stress testing more frequently and be able to vary the underlying assumptions as conditions change or as required by the Federal Reserve.

2. The Covered Company would be required to use the results of its stress testing to set the size of its liquidity buffer and incorporate the stress testing results into its contingency funding plan (both described below).

3. The Proposed Rule's minimum requirements for a Covered Company's stress testing would include:

   (a) The tests would be required to be conducted under at least three stress scenarios—a market-wide stress scenario, an idiosyncratic (firm-specific) stress scenario, and a scenario that combines both market and idiosyncratic stresses—over a minimum of four time horizons, including overnight, 30 days, 90 days and one year.

   (b) The stress scenarios must address the potential impact of market disruptions on the Covered Company and on the actions of other market participants.

   (c) The scenarios must be forward-looking, dynamic and incorporate a range of potential changes to a Covered Company's activities, exposures and risks.

   These requirements have the potential to create ambiguity in the liquidity planning process. First, the requirement that the company include a range of potential (not just likely or anticipated) changes to its activities seems potentially burdensome and unnecessary given the requirement that stress testing be conducted at least monthly. Second, when coupled with the

corporate governance requirements described below, this exercise would seem to be ripe for second-guessing of business judgments by directors and senior management, particularly if certain hypothetical scenarios were not considered but eventually come to pass.

(d) The tests would be required to comprehensively address a Covered Company's activities, including off-balance sheet exposures. The preamble suggests that these may include non-contractual obligations, if "compelled in the interest of mitigating reputational risk."

This requirement may prove difficult for Covered Companies to predict. During the recent crisis, many institutions made impromptu judgment calls as to whether to reimburse customers for certain investments, whether to provide credit or liquidity to funds or special purpose vehicles, or whether to provide liquidity for customers' holdings. The comprehensive nature and tone of the directives in the proposal, however, may lead institutions to be conservative and to inventory all of those situations where the institution "may" come to the aid of another party, even if not legally required. Such an inventory has the potential to be criticized by regulators if the extent of such relationships was not previously known to them. In addition, it is not clear whether potential beneficiaries of such credit or liquidity could use the information in court to argue that an institution anticipated aiding, and should have aided, them in a time of crisis.

4. The Proposed Rule would prescribe certain assumptions for liquidity stress testing, including that cash flow sources for the first 30 days of the stress scenario be limited to only unencumbered and highly liquid assets and that assets used as a cash flow source have appropriate haircuts for credit risk and market volatility.

Unlike the single counterparty credit limits and the Federal Reserve's existing capital and affiliate transaction rules, the proposal does not provide guidance as to what the haircut assumptions should be, although the Federal Reserve requests comment on this point.

5. It would appear that cash flow projections and stress testing also would be important components of a Covered Company's resolution and recovery planning.[37] Indeed, the Proposed Rule suggests that cash flows and stress testing may need to be analyzed by legal entity, business line, and jurisdiction—concepts which are of particular importance in recovery and resolution planning.

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[37] The Federal Reserve and the Federal Deposit Insurance Corporation (the "FDIC") have finalized rules requiring Covered Companies to develop resolution plans. See 12 C.F.R. Part 243 and Part 381.

D. Liquidity Buffer Requirement

1. The only quasi-quantitative liquidity requirement that would be imposed by the Proposed Rule is the requirement to maintain a liquidity buffer. The preamble states that this requirement is "consistent with the effort towards developing a comprehensive liquidity framework that will eventually incorporate the [Basel Committee's Liquidity Coverage Ratio] standard."

   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.

2. Specifically, a Covered Company would be required to maintain a liquidity buffer of unencumbered and 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." It appears, however, that 30 days of funding is only a floor, as the Proposed Rule would also require that the size of the liquidity buffer "align … [with] the [C]overed [C]ompany's capital structure, risk profile, complexity, activities, size and any other risk related factors that are appropriate, and [its] established liquidity risk tolerance."

3. The Proposed Rule defines "highly liquid assets" to include cash and securities issued or guaranteed by the U.S. government, a U.S. government agency, or a GSE. The definition would also include any other asset that the Covered Company demonstrates to the Federal Reserve:

   (a) Has low credit and market risk;

   (b) Is traded in an active two-way secondary market that has observable market prices, committed market-makers, a large number of participants and high trading volume; and

   (c) Is a type of asset historically purchased in periods of financial market distress (i.e., in a flight to quality).

   The preamble suggests that "plain vanilla" corporate bonds (i.e., non-structured, non-subordinated and issued by a strong non-financial company) may satisfy these requirements.

   The asset pool for the liquidity buffer would be required to be "sufficiently diversified" and assets would be required to be discounted for credit and market risk.

   The definition of "highly liquid assets" is broader than the Basel Committee's proposal for a liquidity coverage ratio because it would include agency mortgage-backed securities without limit as well as other assets that satisfy the

Federal Reserve's criteria. Accordingly, the proposal seems to confirm that the Federal Reserve is responsive to industry concerns about the restrictive nature of the liquidity coverage ratio proposed by the Basel Committee and may presage similarly favorable revisions to the Basel III liquidity proposal.

The Proposed Rule does not contain a process for demonstrating to the Federal Reserve that an asset meets the liquidity criteria. While it is possible that the Federal Reserve anticipates that firms will obtain individual guidance regarding specific assets, it would more equitable, more transparent and more efficient for the Federal Reserve to issue guidance to the industry regarding specific assets or classes of assets.

Governor Tarullo has made recent public statements suggesting that the Federal Reserve may be willing to allow banking organizations to use certain large-cap equities in their liquidity pools for purposes of the liquidity buffer and is proposing the same before the Basel Committee with respect to the liquidity coverage ratio (the "LCR") given that these equity securities retained their liquidity during the 2008 crisis.[38] Recent stresses in the European markets appear to confirm that such equity securities are reliably liquid in periods of financial distress.[39] On the other hand, it is important to emphasize that in the context of emergency lending operations, the Federal Reserve applies higher haircuts to equities than other fixed-income type assets because of their price volatility. Accordingly, it would be reasonable to assume that even if certain large-cap equities were deemed to be highly liquid assets for purposes of the liquidity buffer or the LCR, quantitative restrictions on their inclusion are possible.

4. The Proposed Rule's definition of "unencumbered" would reach beyond the conventional understanding of the term to require that an asset not be designated as a hedge to a trading position.

This definition would artificially restrict the determination of assets that may be counted toward short-term liquidity needs. Indeed, as in the example provided by the preamble (where a corporate bond is "encumbered" because it hedges a position in a bond index), the "trading position" and the related "hedge" might each be of sufficient quality that the Covered Company could liquidate them both

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[38] Governor Daniel K. Tarullo, Q&A Following Testimony Before the Senate Committee on Banking, Housing and Urban Affairs Regarding Continued Oversight on the Implementation of the Wall Street Reform Act (Dec. 6, 2011) Federal News Service Transcript, p. 38.

[39] See Brooke Masters, Bank Regulation Battle Focuses on Liquidity, Financial Times (Dec. 29, 2011), available at http://www.ft.com/intl/cms/s/0/7011eabc-25b0-11e1-9c76-00144feabdc0.html#axzz1kF0rwvnv.

simultaneously in a liquidity crunch, particularly in a more standardized derivative market as envisioned by Title VII of the Dodd-Frank Act.

E. Contingency Funding Plan

1. The Proposed Rule would require a Covered Company to establish and maintain a contingency funding plan that sets out its strategies for addressing liquidity stress events. The company would be required to update the plan at least annually and whenever market and idiosyncratic conditions warrant it.

2. The Proposed Rule sets out four required components of a contingency funding plan:

   (a) A quantitative assessment that incorporates information from the company's liquidity stress testing. The plan would have to use stress test information to identify liquidity stress events that would have a significant impact on the Covered Company's liquidity, assess the level and nature of that impact, assess available funding sources and needs during these events, and identify alternative funding sources that may be used during these events. The preamble suggests that a Covered Company should include "realistic assessments of the behavior of funds providers" during a liquidity stress event.

   This concept of incorporating realistic assumptions regarding the reactions of funds providers seems also to be more helpful than the Basel Committee's required liquidity stress assumptions that all committed credit and liquidity facilities provided by the company will be fully drawn, but any credit and liquidity facilities provided to the company will be unavailable.

   (b) An event management process that sets out the Covered Company's procedures for managing liquidity during an identified liquidity stress event, which must include, among other requirements, effective reporting and communication with outside parties, including the Federal Reserve and other relevant supervisors.

   (c) Procedures for monitoring emerging liquidity stress events, including early warning indicators customized to the Covered Company. The preamble suggests that these would include "traditional" indicators such as widening credit spreads and the deteriorating financial condition of the Covered Company, but also more qualitative indicators such as negative publicity concerning an asset class owned by the Covered Company.

   (d) Periodic testing of the components of the contingency funding plan to assess its reliability during liquidity stress events. This must include operational simulations, as well as testing of the methods the Covered Company will use to access alternative funding sources.

3. The preamble suggests that a Covered Company that includes the use of discount window funding in its contingency funding plan must project how, and within what time frame, it will replace discount window draws with permanent funding. This requirement would seem to be at odds with the concept of the Federal Reserve as the "lender of last resort." Perhaps the Federal Reserve is signaling that an over-reliance on the discount window in non-stress or moderately stressed scenarios might require rethinking. However, in a broad market stress scenario, after liquidity buffers are used, it would seem that the discount window may be one of the only sources of liquidity in the market.

F. Specific Liquidity Risk Limits

1. The Proposed Rule would also require that a Covered Company establish and maintain limits on potential sources of liquidity risk, including limits on:

   (a) Concentrations of funding by instrument type, single counterparty, counterparty type and secured and unsecured funding;

   (b) The amount of liabilities that mature within various time horizons; and

   (c) Off-balance sheet and other exposures that could create funding needs during liquidity stress events, including non-contractual exposures.

   The mandated items are relatively general and the preamble does not provide additional guidance on how Covered Companies should interpret these broad categories or how (and within what range) the limits should be set.

G. Corporate Governance Mandates

1. The Proposed Rule would mandate a number of specific actions by the board of directors, the risk committee, senior management and the independent review (audit) function of the Covered Company, including recurring reviews and determinations at regular intervals. The Proposed Rule states that directors and management should undertake more frequent reviews and approvals "as market conditions and idiosyncratic conditions warrant".

   Several sections of the proposal would elevate corporate governance guidance that usually would appear in Federal Reserve SR letters or similar pronouncements to the status of full regulatory requirements. Notably, there are specific tasks in the liquidity and risk management rules that are assigned solely to the board of directors. This follows the regulatory trend, evidenced during and after the recent credit and liquidity crisis, to force financial institutions to have greater central control over not only the "tone" and "culture" at a firm, but also core safety and soundness processes and the impact of business lines on those processes.

   Some requirements, particularly when looked at with perfect hindsight, could provide examiners with the ability to second-guess the business judgment of the

board of directors, and potentially cite institutions or boards of directors for violations of regulations.

The requirements described below would seem to impose a single, relatively specific liquidity risk management structure onto Covered Companies. Existing (or potential) alternative approaches could be precluded by the Proposed Rule for reasons unrelated to substance. For example, it appears that delegating significant liquidity risk management to a Covered Company's subsidiaries or establishing varying liquidity risk tolerances for various subsidiaries may not be permissible under the Proposed Rule. As noted above, neither the Proposed Rule nor the preamble's guidance is clear on how the corporate governance and testing requirements are to apply beyond the Covered Company to its material subsidiaries and business lines.

2. The <u>board of directors</u> of the Covered Company would be required to:

   (a) At least annually, establish the Covered Company's liquidity risk tolerance. In making this determination, the board would be required to consider the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.

   As a nod to the exercise of business judgment by the board of directors, the Federal Reserve notes that the board is expected to take into account the benefits of maintaining liquidity, as well as the opportunity costs and impact on profitability of maintaining too much liquidity.

   (b) At least semi-annually, review information provided by senior management to determine whether the Covered Company is managed in accordance with the established liquidity risk tolerance.

   (c) At least annually (and whenever it is materially revised) review and approve the Covered Company's contingency funding plan.

3. The <u>risk committee</u> of the board of directors (or a designated subcommittee thereof) would be required to undertake substantial reviews and approvals. Specifically, it would be required to, among other things:

   (a) Review and approve the liquidity costs, benefits and risks of each significant new business line and each significant new product. The committee (or subcommittee) would be required to consider whether the liquidity risk of the new business line or product is within the company's established liquidity risk tolerance, both under current conditions and under liquidity stress.

   (b) At least annually, review significant business lines and products to determine whether either has created any unanticipated liquidity risk, and to determine whether the liquidity risk of either continues to be within the established liquidity risk tolerance.

(c) At least quarterly, review the cash flow projections for consistency with the established liquidity risk tolerance, review and approve the liquidity stress test methodologies, review the results of the stress test, approve the size and composition of the required liquidity buffer, and review and approve the specific liquidity risk limits required by the Proposed Rule.

4. Senior management would be required to establish and implement strategies, policies and procedures for managing liquidity risk and regularly to report to the risk committee (or designated subcommittee thereof) on the liquidity risk profile of the Covered Company.

5. The independent review function of the Covered Company would be required, at least annually, to review and evaluate the Covered Company's liquidity risk management processes.

6. The Proposed Rule would require a Covered Company to establish and maintain procedures and systems for:

(a) Compliance with, and oversight of, the liquidity stress testing requirements.

(b) Monitoring its assets pledged and available to be pledged as collateral.

(c) Monitoring and controlling liquidity risk exposures and funding needs within and across significant legal entities, currencies and business lines.

More broadly, this requirement signals that liquidity planning is not an exercise solely for the consolidated Covered Company but is required for all material entities within a Covered Company's group. Yet, as noted above, there is not sufficient guidance as to how and whether the various specific requirements are to apply to subsidiaries or business lines. And there would still be significant reliance on the centralization of liquidity risk management with the board of directors, the board's risk committee and senior management of the Covered Company.

This requirement coincides with the resolution planning requirement that Covered Companies plan to maintain funding to "core business lines", "critical operations" and "material entities" during the stress or failure of the company.[40]

(d) Monitoring intraday liquidity risk exposure, including intraday transaction settlement operations.

(e) Monitoring compliance with specific liquidity risk limits.

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[40] See, e.g., 12 C.F.R. §§ 243.4(c)(1)(iii) and 381.4(c)(1)(iii) (Federal Reserve and FDIC resolution planning rules).

H. Other Matters Related to Liquidity Management.

The Federal Reserve's guidance on liquidity management was eagerly anticipated by the industry because of the interaction of these rules with the Volcker Rule proposal by several regulatory agencies.[41] The Volcker Rule proposal would provide an exemption from the definition of "trading account" for accounts used for liquidity management purposes, provided that certain policies and procedures are maintained. In addition, the activity would be required to be consistent with the regulatory agencies' "supervisory requirements, guidance and expectations regarding liquidity management." Entities subject to the Volcker Rule will likely want to use this exception, and other Volcker Rule carve-outs, to facilitate asset-liability management activities consistent with safety and soundness requirements. However, the concept of liquidity management in the current proposal likely does not encompass the full spectrum of asset-liability management that Covered Companies are expected to undertake, as derivatives and instruments of varying levels of liquidity are often used to address balance sheet, tenor and customer activity mismatches.

V. STRESS TESTING

A. Stress Testing Requirements Generally

1. The Federal Reserve would apply stress test requirements to each Covered Company, as well as to BHCs, SLHCs, and state member banks that are not Covered Companies but have more than $10 billion in average total consolidated assets over the previous four reporting quarters ("over $10 billion companies").[42]

2. The Proposed Rule calls for two types of stress tests:

   (a) Supervisory stress tests that would apply only to Covered Companies and would require Covered Companies to submit a range of data annually to enable the Federal Reserve to conduct its own stress test; and

   (b) Company-run stress tests that would apply to both Covered Companies and over $10 billion companies. Covered Companies would be required to perform two company-run stress tests annually (one mid-year and one at the end of the year) and over $10 billion companies would be required to perform one (at the end of the year).

3. The stress testing requirements build on the Federal Reserve's 2009 Supervisory Capital Assessment Program ("SCAP")[43], the Federal Reserve's 2010 and 2011

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[41] See 76 Fed. Reg. 68,846 (Nov. 7, 2011).

[42] SLHCs would not become subject to the company-run stress test requirements until the Federal Reserve promulgates final rules for risk-based capital and leverage requirements for SLHCs.

[43] See, e.g., [SCAP]: Design and Implementation (Apr. 24, 2009); [SCAP]: Overview of Results (May 7, 2009).

Comprehensive Capital Analysis and Review ("CCAR") programs [44] and supervisory guidance on stress testing for banking organizations with more than $10 billion in total assets issued for comment in June 2011 by the Federal Reserve, the OCC and the FDIC.[45]

4. The Federal Reserve has attempted to stagger the time frames for submission of data and results to minimize conflicts with other regulatory or disclosure filings, but Covered Companies should note that the end-of-year stress test coincides with the submission of the annual capital plan and the mid-year stress test coincides with the annual resolution plan submission. The Federal Reserve also notes that the proposed time frames are illustrative and subject to change.

The company-run and supervisory stress tests appear intended to complement one another and to facilitate the design and implementation of the capital plans that are required under the recently finalized capital plan rule and the stress testing required in connection with the CCAR.[46] However, it remains to be seen whether these stress testing procedures will be aligned in practice. For example, the 2011 CCAR guidance provided for stress testing based on four scenarios—a BHC-defined baseline scenario; a baseline scenario provided by the Federal Reserve; at least one BHC-defined stressed scenario; and a stressed scenario provided by the Federal Reserve. By contrast, the Proposed Rule requires stress testing conducted based on at least three scenarios provided by the Federal Reserve—a baseline, adverse and severely adverse scenario.

B. Supervisory Stress Tests

1. Applicability

All Covered Companies must submit to supervisory stress tests. Covered Companies will be required to comply within the time frames set forth in Appendix A.

2. Information Requirements

(a) The Federal Reserve expects to collect information primarily through the regulatory reporting process and may obtain needed supplemental information through the supervisory process. The Federal Reserve plans to issue a separate information collection proposal to support its annual supervisory stress test analyses. This separate proposal will request comment on any new reporting forms and instructions. Information required to be submitted would include:

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44 See, e.g., [CCAR]: Objectives and Overview (Mar. 18, 2011); [CCAR] Summary Instructions and Guidance (Nov. 22, 2011).

45 76 Fed. Reg. 35,072 (Jun. 15, 2011).

46 See 12 C.F.R. § 225.8. 76 Fed. Reg. 74,631 (Dec. 1, 2011).

(i) Sufficient information to derive robust projections of a company's losses, pre-provision net revenues;

(ii) Allowance for loan losses; and

(iii) Future pro forma capital positions under, at a minimum, the baseline, adverse, and severely adverse scenarios.

The Federal Reserve would also require sufficient information to assist it in estimating likely evolution of the Covered Company's balance sheet and allowance for loan losses.

(b) The Federal Reserve would base its supervisory stress test on all of the relevant data collected by mid-November (through the third quarter regulatory reporting cycle). U nder the capital plan rules, Covered Companies would also be required to submit capital plans by January 5 of each year and these plans would also factor into the review.

3. <u>Methodology</u>

(a) <u>Scenarios</u>

(i) Scenarios would be provided by the Federal Reserve for the supervisory tests and annual company-run tests and would include projections for a range of key financial variables, such as real GDP, the unemployment rate, and equity and property prices. The Federal Reserve would revise these scenarios to reflect changes in outlook over time.

(ii) Scenario types would include baseline, adverse, and severely adverse.

(A) The baseline scenario would consider the most recent macroeconomic outlook expressed by government agencies, other public-sector organizations, and private-sector forecasters.

(B) The adverse scenario would likely include conditions consistent with a moderate recession.

(C) The severely adverse scenario is expected to consist of economic and financial conditions more unfavorable than those in the adverse scenario and may also include factors likely to place notable strains on a t least some business lines.

(iii) To test the sensitivity of trading and similar positions, the Federal Reserve would supplement the scenarios in some cases with

market price and rate "shocks", as well as factors not tied to financial assumptions but that might affect the risk profile of a Covered Company.

(b) The Federal Reserve would calculate each Covered Company's projected losses, revenues, and other factors affecting capital using a series of models and estimation techniques incorporating the variables in the scenarios. The Federal Reserve would focus the stress tests on a forward planning horizon of at least nine quarters.

(c) The Federal Reserve stated that the supervisory stress tests would be standardized across all Covered Companies. To gain a better picture of any company-specific stresses and conditions, the Federal Reserve will look also to the company-run stress tests, the company's capital plan and generally the supervisory process.

(d) The Federal Reserve stated that it will publish, in the future, a detailed overview of its methodology for the supervisory stress tests.

(e) While the proposal provides additional procedural detail on supervisory stress testing, 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 as to whether contingent capital instruments that convert to Tier 1 Common under stress scenarios could provide effective loss absorption for purposes of either the supervisory or company-run stress tests, even if they are not viewed as regulatory capital with respect to minimum requirements.

4. Results

(a) Description of assessment. The Federal Reserve's evaluation would be designed to determine whether the Covered Company has the capital, on a total consolidated basis, necessary to absorb losses under the baseline and stress scenarios.

(b) Communication of results. The Dodd-Frank Act requires the Federal Reserve to publish a summary of the stress test analyses. By March of each year, the Federal Reserve would convey to each Covered Company the results and explain the information the Federal Reserve expects to make public.

(c) Publication. The Federal Reserve proposes to publish a high-level summary of company-specific results by mid-April of each calendar year. This high-level summary is expected to include estimated losses, estimated pre-provision net revenue, estimated allowance for loan losses, and estimated pro forma regulatory and other capital ratios.

Between the time of communication of the results to a Covered Company and the expected date of public release, Covered Companies should engage in a dialogue with the Federal Reserve regarding the scope of the public release and the preservation of confidentiality for any information not otherwise required to be in the public release. The Federal Reserve is required to publish only a "summary" of the results of the stress test by the Dodd-Frank Act, and has stated that the confidentiality of information submitted to the Federal Reserve in the context of stress test will be determined in light of applicable exemptions from the Freedom of Information Act. The challenge for Covered Companies will be to reach agreement with the Federal Reserve on scope of disclosure in the face of the statutory requirement for publication.

(d) Post-assessment actions by the Covered Company: A Covered Company would be required to consider the Federal Reserve's analyses when making changes to its capital structure (including the level and composition of capital); when analyzing or changing its exposures, concentrations, and risk positions; when developing recovery and resolution plans and capital plans; and for the purpose of improving overall risk management.

Application of the early remediation framework to the Covered Company may also be considered based on test results.

C. Company-Run Stress Tests

1. Applicability

(a) End-of-year, company-run stress tests must be conducted by both Covered Companies and over $10 billion companies based on information as of September 30, with the exception of trading and counterparty exposures, over at least a nine-quarter forward-looking planning horizon. The Federal Reserve expects to communicate the as-of date for trading and counterparty exposures sometime in the fourth quarter of each year. Submission of stress test results would be expected by January 5 each year.

(b) Each Covered Company (but not over $10 billion companies) would also be required to conduct a second, mid-year stress test using the company's financial data as of March 31 of that year. Submission of this second test's results would be expected by July 5 of each year.

(c) Covered Companies and over $10 billion companies would become subject to the rule in accordance with the time frames set forth in Appendix A.

(d) Company-run stress test requirements apply to the parent company and to each subsidiary regulated by a primary federal financial regulatory agency

that has more than $10 billion in total consolidated assets. The Federal Reserve indicated that it would coordinate planning with the OCC and FDIC.[47]

2. Methodologies

(a) Scenarios

(i) Each company required to run the end-of-year, company-run stress test would have to employ the three scenarios—baseline, adverse and severely adverse—used in the supervisory stress tests and any additional conditions the Federal Reserve determines appropriate.

(ii) For the additional mid-year company-run stress-tests for Covered Companies only, the Covered Company would be required to develop and employ its own scenarios reflecting a minimum of three sets of economic and financial conditions—baseline, adverse, and severely adverse—and to apply additional conditions the Federal Reserve determines appropriate.

(b) Policies and procedures. Companies required to conduct company-run stress tests would have to ensure stress test effectiveness through a system of controls, oversight, and documentation, to be approved and annually reviewed by their boards of directors and senior management. Each Covered Company would also need to describe its plan for scenario development for the additional stress test.

(c) Calculations required. Potential losses, pre-provision revenues, allowance for loan losses, and future pro forma capital positions over a planning horizon of at least nine quarters.

3. Report Content

(a) Before requiring Covered Companies to perform the company-run stress tests, the Federal Reserve will publish for comment specific forms and instructions for the report under a separate information collection proposal. Where relevant, a Covered Company would be able to refer to information submitted in connection with its capital plan rule. (Capital

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[47] The FDIC and OCC proposals are generally similar to the Federal Reserve's. See 77 Fed. Reg. 3408 (Jan. 24, 2012) available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-24/pdf/2012-1274.pdf (the OCC's proposed stress test regulations); 77 Fed. Reg. 3166 (Jan. 23, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-01-23/pdf/2012-1135.pdf (the FDIC's proposed stress test regulations).

plans would be expected to be submitted on a similar time frame as the annual company-run stress test results.)

(b) Reports would likely include, but not be limited to, the following:

(i) Qualitative information: a general description of the use of stress tests in the company's capital planning and capital adequacy assessments; methodologies used to perform the tests; and a description of the types of risks as well as assumptions employed in the tests. Covered Companies would be expected to include a description of scenarios developed and key variables used for the additional mid-year stress tests.

(ii) Quantitative information would include, but not be limited to, estimations of: pro forma capital levels and capital ratios; losses by exposure category; pre-provision net revenue; allowance for loan losses; total assets and risk-weighted assets; aggregate loan balances; and potential capital distributions over the planning horizon.

4. Results

(a) Supervisory review of stress test process

(i) The Federal Reserve would analyze the quality of the company's stress test processes and related results, and feedback likely would be provided through the supervisory process.

(ii) Companies would be required to consider the results and analyses of stress tests when making changes to the company's capital structure (including the level and composition of capital); when analyzing or changing its exposures, concentrations, and risk positions; when developing recovery and resolution plans and capital plans; and for the purpose of improving overall risk management.

(b) Publication of results

(i) Companies must publish a summary of the results within 90 days of submitting the report to the Federal Reserve. A Covered Company conducting an additional mid-year stress test would also be required to publish a summary of the results of this additional test within 90 days of submitting the required report to the Federal Reserve.

(ii) The summary may be published on the company's website or any other forum reasonably accessible to the public. A subsidiary

could publish its summary on its parent company's website or in another form along with the parent company's summary.

(iii) Publicly disclosed information would need to include: a description of the types of risks being included in the stress test; a high-level description of scenarios and key variables developed by a Covered Company for its additional stress test; a general description of the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon; and aggregate losses, pre-provision net revenue, allowance for loan losses, net income, and pro forma capital levels and capital ratios over the planning horizon under each scenario.

(iv) It is not clear whether the Federal Reserve has committed to provide feedback to a Covered Company on the company-run stress tests prior to the time the Covered Company would be required to publicly disclose the results of its stress tests.

VI. EARLY REMEDIATION FRAMEWORK

A. Overview

1. In the preamble, the Federal Reserve indicated that the early remediation framework was designed to address the shortcomings of the prompt corrective action ("PCA") regime[48] during the 2008 financial crisis, as identified by the Government Accountability Office ("GAO") in its June 2011 study.[49] The PCA Regime applies only to insured depository institutions ("IDIs").

   (a) In particular, the PCA regime's primary triggers—regulatory capital ratios—were identified as lagging indicators of an IDI's financial condition. An IDI's capital ratios could be at or above minimum required levels even while its financial condition was rapidly deteriorating.

   (b) Furthermore, the GAO Study determined that "the PCA regime failed to prevent widespread losses to the deposit insurance fund", and that bank supervisors did not take action as quickly as authorized under the regime.

2. The early remediation framework would aim to remedy these shortcomings by including as triggers forward-looking measures of a Covered Company's financial

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[48] 12 U.S.C. § 1831o and regulations promulgated thereunder.

[49] Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness, GAO-11-612 (June 23, 2011) (the "GAO Study"), available at http://www.gao.gov/new.items/d11612.pdf.

condition, and, in certain instances, by removing supervisory discretion in taking action against Covered Companies under the early remediation framework.

B. Triggers

1. The early remediation framework operates through several quantitative and qualitative thresholds that function as "triggers" for increasing levels of scrutiny and restrictions on a Covered Company that evidences financial decline and compliance weaknesses.

2. Although the early remediation framework retains the use of regulatory risk-based capital and leverage ratios as triggers, the Federal Reserve has embedded a significant number of the requirements of the Proposed Rule as additional triggers. In the Federal Reserve's view, these triggers are based on more forward-looking indicators of financial distress, including supervisory stress test results and compliance weaknesses with respect to the enhanced risk management and liquidity standards.

3. Detail on the exact trigger thresholds is set forth in the table in Appendix C. Below we provide a brief summary of, and some insights into, how the triggers are designed to operate.

   The liquidity and risk management triggers described below do not contain any objective or quantitative thresholds. Although the risk-based capital and stress test triggers contain quantitative thresholds for imposing Level 2 and Level 3 restrictions, entrance into Level 1 remediation is based primarily on "weaknesses" in capital planning or stress testing compliance. Therefore, the early remediation framework would rely significantly on subjective analyses of a Covered Company's financial and compliance condition. The industry may want to seek further clarity and predictability in order to be able to avoid issues that the Federal Reserve may believe should lead to heightened scrutiny or restrictions under the early remediation framework.

4. <u>Risk-Based Capital Triggers</u>. The early remediation framework would, similar to the PCA regime, trigger as capital ratios of a Covered Company fall below prudential thresholds. The preamble states that the capital standards used will be re-evaluated in light of the proposal to implement Basel III's reforms to the risk-based capital regime, and changes may be proposed when the Basel III implementing proposal is released.

   Capital and leverage triggers would lead to mandatory remediation actions once a Covered Company fell below the "well capitalized" level, earlier than the corresponding requirements under PCA.

5. <u>Stress Test Triggers</u>. The early remediation framework would include both qualitative and quantitative triggers based on the Proposed Rule's stress test requirements.

(a) Although the risk-based capital triggers key off a Covered Company's <u>actual</u> Tier 1 capital, total capital and leverage ratios, the stress test triggers key off a forward-looking stress analysis of only the Tier 1 common risk-based capital ratio, a new ratio that the Federal Reserve has included in its capital planning requirements and that appears in Basel III requirements. It is not clear why the stress analysis is limited to the Tier 1 common risk-based capital ratio, or whether stress analysis of Tier 1 capital, total capital and leverage ratios (in contrast to their actual levels) would result in application of the early remediation framework in addition to any restrictions imposed under the capital plan rules.

(b) The stress test trigger also keys off the impact on the Tier 1 common risk-based capital ratio of the "severely adverse" stress scenario. This would seem potentially restrictive because the trigger does not factor in whether such a scenario is "probable". The Federal Reserve in fact commented, in the preamble description of the stress test requirements, that "outputs under the adverse and severely adverse scenarios should not be viewed as most likely forecasts or expected outcomes."

6. <u>Liquidity Triggers</u>. The Federal Reserve would include a qualitative measure of "compliance" with liquidity risk management standards, but is seeking comment on the possible use of a quantitative liquidity trigger. The Federal Reserve, however, expressed concern in the preamble that an objective, quantitative trigger could "exacerbate funding pressures" at a Covered Company.

These statements by the Federal Reserve imply that the Federal Reserve intends to make some or all of the early remediation information about an individual Covered Company public. However, the Federal Reserve does not explicitly state that it will, and such an implication would be at odds with the proposed Level 2 remediation actions of entering into a <u>non-public</u> memorandum of understanding with the Federal Reserve. Clarity should be sought from the Federal Reserve on what public disclosures will be made surrounding the early remediation framework.

Although the Federal Reserve does not directly propose a quantitative liquidity trigger, clearly one of the proposed liquidity risk management standards is the quasi-quantitative liquidity buffer requirement.

7. <u>Market Indicator Triggers</u>. The early remediation framework also would use forward-looking market-based indicators. At least initially, the market indicators are intended to be used only to bring a Covered Company within Level 1 of the early remediation framework, and would not trigger higher levels of remediation because of the Federal Reserve's expressed concern that market indicators may be misleading or inaccurate. The Federal Reserve expects to review its market indicator methodology annually, and may revise its use (including by adjusting threshold levels) based on its own experience and on comments from market participants.

(a) The Proposed Rule would include both equity- and debt-based market indicators, as set forth in Appendix D.

(b) Covered Companies would be placed under heightened supervisory review if at least one market indicator crosses, for a sustained period, the thresholds defined by:

(i) The Covered Company's own past-performance, or that of the median of its "low-risk" peer group, on a 5-year rolling basis (so called "time-variant" triggers); or

(ii) The historical distributions of market indicators over a fixed period of time for the Covered Company or its peer group (so called "time-invariant" triggers).

(c) The Federal Reserve would establish threshold triggers with respect to any market indicators that it determines to use in the final rule.

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 initially would be used only to initiate consideration of the first remediation levels, and not to place a Covered Company into a more restrictive remediation level.

Since, by definition, the Proposed Rule applies to only the largest financial institutions, it is unclear how a "low risk" peer group would be determined in contrast to simply a "peer group".

8. Risk Management Triggers. Deficiencies in compliance with the risk management and risk committee requirements of the Proposed Rule would also trigger early remediation actions.

C. Remediation Actions

1. The early remediation framework is comprised of four levels of remediation requirements, with increasing degrees of restrictions on a Covered Company's activities:

(a) Level 1 (Heightened Supervisory Review);

(b) Level 2 (Initial Remediation);

(c) Level 3 (Recovery); and

(d) Level 4 (Recommended Resolution).[50]

2. In the context of the Proposed Rule, the Federal Reserve has repeatedly stated that it has the ability to tailor the heightened prudential standards to the attributes of a specific Covered Company. However, in the early remediation framework, the Federal Reserve has removed discretion and made the remedial actions under Levels 2 and 3 mandatory, except that the Federal Reserve may issue an approval for acquisitions and establishment of offices under Level 2 remediation. A key question will be whether the lack of ability to tailor a remedial course of action will prove to be a blunt and potentially inappropriate instrument in certain cases. The Federal Reserve has explicitly reserved the authority to add to the basic restrictions triggered by the Rule, but not to waive them.

On the other hand, the Federal Reserve potentially has hampered predictability by also stating in the preamble that the early remediation framework "supplements" existing authority to initiate supervisory actions on Covered Companies or to "take remedial actions enumerated in the early remediation regime on a basis other than a triggering event."

3. If a Covered Company were to enter Level 1 remediation or change remediation levels, the Federal Reserve would notify the FDIC and the primary regulators of a Covered Company's subsidiaries.

4. Level 1 (Heightened Supervisory Review)

(a) Trigger. Level 1 remediation would be triggered when a Covered Company shows weaknesses in capital structure, capital planning or risk management that indicate that a further decline of the financial condition of, or compliance by, the Covered Company is "probable," even though the Covered Company continues to maintain regulatory capital ratios above well-capitalized thresholds.

(b) Actions. The Covered Company would be subject to "targeted" supervisory review (to be completed by the Federal Reserve within 30 days), after which the Federal Reserve may elevate the Covered Company to a higher level of remediation. The Federal Reserve may also use its general supervisory authority to direct the Covered Company to address any problems identified in the review. There are no non-discretionary restrictions on the Covered Company at this level.

The Federal Reserve did not provide any insights into its methodology for deciding whether to elevate a Covered Company to a higher remediation level based on its targeted review. Presumably, the implication is that the Federal

[50] In defining the Level 1, 2 and 3 remedial actions, the actual text of Section 252.162 of the Proposed Rule refers to an exception in "paragraph (e)" of that section, but there was no paragraph (e) in the release.

Reserve could put a Covered Company into a higher level after a Level 1 review even if the Covered Company did not cross any of the threshold triggers for the higher levels.

5. Level 2 (Initial Remediation)

(a) Trigger. Level 2 remediation would be triggered when a Covered Company is in the "initial stages of financial decline". Specifically, the Covered Company would trigger Level 2 if it fails to keep its risk-based capital and leverage ratio levels above those required to be well-capitalized (but maintains levels above Level 3 requirements), fails to maintain a 5% Tier 1 common ratio in any quarter in the planning horizon for the severally adverse stress test, or shows multiple deficiencies in meeting enhanced risk management or liquidity standards.

(b) Actions. Actions are designed to preserve and increase the Covered Company's capital cushion, limit its size and level of interconnectedness, and focus its managers' attention on underlying financial and risk management problems. The Covered Company would:

(i) Be prohibited from making capital distributions in any quarter greater than 50% of the average of the Covered Company's net income for the preceding two quarters;

(ii) Have to refrain from acquiring controlling interests in any other companies or establishing new offices, branches or business lines unless it receives prior Federal Reserve approval;[51]

Historically when it has imposed restrictions on BHCs, prior to this Proposed Rule, the Federal Reserve has generally focused on curtailing expansionary activities that may distract management from the task of curing the problems identified at the Covered Company.

It is not clear whether a Covered Company could request a blanket prior approval for de minimis activities such as the making of immaterial controlling investments or the establishment of minor offices or branches that do not distract management from the task of rehabilitating the Covered Company.

At times, branches, offices and subsidiaries are created based on a corporate structural requirement or in the ordinary course of a particular business and are not intended to be expansionary. Covered Companies may wish to seek guidance as to the Federal

[51] Such approval is to be determined on a "case-by-case" basis.

Reserve's core concerns with corporate structural changes in order to gain clarity on what may or may not be permitted.

In addition, it is not clear what form the prior approval would take or what the standard of review would be—would supervisory and/or examiner approval be sufficient, or would the Covered Company be required to receive a formal order of the Federal Reserve?

(iii) Be prohibited from letting its daily average total assets or its daily average risk-weighted assets increase quarter-over-quarter by more than 5% or year-over-year by more than 5%; and

(iv) Be required to enter into a non-public memorandum of understanding or undergo other enforcement actions.

In addition to these non-discretionary measures, the Federal Reserve may impose other limitations or conditions on the Covered Company's (or its affiliates') activities and conduct, provided these actions are "consistent with" Title I of the Dodd-Frank Act.

6. Level 3 (Recovery)

(a) Trigger. Level 3 remediation is triggered when a Covered Company is in the "advanced stages" of financial distress. Specifically, the Covered Company would trigger Level 3 if its risk-based capital and leverage ratios are below what is required for Level 2, it fails to maintain a 3% Tier 1 common ratio in any quarter in the planning horizon for the severely adverse stress test, or it is in substantial non-compliance with the enhanced risk management or liquidity standards. Level 3 could also be triggered if the Covered Company's risk-based capital and leverage ratios are below well-capitalized standards for two consecutive complete quarters.

(b) Actions. Actions are designed to prevent a Covered Company from increasing its risk profile, and to maximize capital conservation. A Covered Company would:

(i) Be prohibited from making any capital distributions, and prohibited from balance sheet and risk-weighted asset growth;

(ii) Not be able to make any acquisitions in other companies, establish offices, branches or new business lines;

(iii) Be required to adopt a capital restoration plan (under a written agreement or other formal enforcement action); and

(iv) Be prohibited from increasing compensation or paying bonuses to directors and senior executives.

The Federal Reserve would be able to require changes to the composition of the Covered Company's directors and senior executives. The preamble suggests that, if the Federal Reserve determines that management is the "primary cause" of the Covered Company's distress, it could take appropriate action to prevent management from further increasing the Covered Company's risk profile.

A Covered Company's failure to comply with any written agreement or other enforcement action could result in the Federal Reserve requiring the Covered Company to divest assets "identified by the [Federal Reserve] as contributing to the [C]overed [C]ompany's financial decline or posing substantial risk of contributing to further financial decline of the [C]overed [C]ompany." The Federal Reserve also reserves the right to restrict transactions with affiliates under Level 3.

The PCA regime sets forth the parameters of the capital restoration plan (including criteria for accepting a plan and a deadlines for submission and review), while the Proposed Rule does not provide similar parameters. Presumably such parameters would be set forth in the individual written agreement or other enforcement action to which the Covered Company would become subject.

The Federal Reserve explains in the preamble that restrictions on controlling investments under Level 2 remediation would continue to permit acquisitions for purposes of dealing and market-making. However, under Level 3 remediation, the prohibition is <u>not</u> limited to controlling interests but, rather, applies to <u>any</u> interest in another company. Although the Federal Reserve specifically highlighted the impact to trading and dealing businesses under Level 2 remediation, with regard to Level 3 remediation the Federal Reserve only notes generally that it understands that the actions would be "potentially disruptive to aspects of the company's business." Presumably, the Federal Reserve did not intend to discontinue dealing, market-making and customer facilitation trades in equities and similar interests under Level 3 remediation, but the Rule should be more explicit about the intended impact on such businesses.

7. <u>Level 4 (Resolution Assessment)</u>

(a) <u>Trigger</u>. Level 4 is triggered when a Covered Company fails to meet certain very low risk-based capital or leverage requirements.

(b) <u>Actions</u>. The Federal Reserve, after consideration, may recommend to the Department of Treasury and the FDIC that the Covered Company be resolved under the orderly liquidation authority of Title II of the Dodd-Frank Act because of the Covered Company's financial decline or risk to the stability of the U.S. financial system.

VII. RISK MANAGEMENT

A. The Proposed Rule mandates different levels of risk management infrastructure based on a two-tier categorization of firms:

1. Publicly traded BHCs that have greater than $10 bi llion in average total consolidated assets over the last four reporting quarters and are not Covered Companies ("$10 Billion BHCs") would be subject to enhanced risk management standards.

2. Covered Companies would be subject to even higher risk management standards.

B. Both Covered Companies and $10 Billion BHCs would be required to establish a risk committee of the board of directors. The risk committee would be charged with documenting and overseeing the risk management practices of the firm's enterprise-wide operations on a global basis. Accordingly, the Proposed Rule provides specific guidance as to the corporate governance structure of the risk committee:

1. First, the risk committee must be chaired by an independent director.

   (a) For publicly traded companies, an independent director must meet the independence standards in the SEC's Regulation S-K, Item 407.

   (b) In the case of a Covered Company that is not publicly traded, the Covered Company must satisfy the Federal Reserve that the chair of the risk committee would qualify as an independent director under the listing standards of a security exchange were the Covered Company to be listed on such exchange.

   (c) A director would fail to be independent if the director is or was an officer or employee of the Covered Company or $10 Billion BHC in the last 3 years, or has an immediate family member that is or was an executive officer of the Covered Company or $10 Billion BHC in the last 3 years.

2. Second, and less specific, the risk committee must have at least one member with a level of risk management expertise commensurate with the firm's potential systemic risk.

3. Third, the Proposed Rule would establish certain procedural requirements for risk committees. Specifically, a firm's risk committee would be required to:

   (a) have a formal, written charter that is approved by the board of directors;

   (b) meet regularly and as needed; and

(c) fully document and maintain records of such proceedings, including risk management decisions.

4. Fourth, the risk committee is charged with overseeing and approving the enterprise-wide risk management policies and procedures of the firm.

C. Covered Companies, but not $10 Billion BHCs, have heightened risk committee and risk management requirements.

1. The Proposed Rule requires the risk committee at Covered Companies to report directly to the board of directors and receive and review regular reports from the firm's Chief Risk Officer ("CRO"). Also the risk committee must be a standalone committee of the board not housed within, or part of, another committee.

2. Each Covered Company is required to designate a CRO charged with implementing and maintaining the risk management framework overseen and approved by the risk committee.

   (a) As with the risk committee, the CRO would be required to have risk management expertise commensurate with the risk profile of the Covered Company.

   (b) The CRO must report directly to the risk committee and to the chief executive officer of the firm.

   (c) The CRO's compensation must be structured in such a way as to provide for an objective assessment of the firm's risks.

   (d) The CRO must provide the risk committee with regular risk reports for its review.

Many, but not all, of the largest BHCs already have stand-alone risk committees at the board level, and most have a chief risk officer. Even those institutions would, however, need to ensure that the current mandates and structure of their committees were consistent with the requirements of the Federal Reserve.

VIII. DEBT-TO-EQUITY LIMITATIONS ON CERTAIN COVERED COMPANIES

A. The debt-to-equity limitations of the Proposed Rule would apply to a Covered Company[52] only if the FSOC were to determine that:

1. The Covered Company poses a grave threat to the financial stability of the United States, and

2. The imposition of the debt-to-equity requirement is necessary to mitigate systemic risk.

[52] The Dodd-Frank Act exempts any FHLB from the requirements of this subpart.

3. The Dodd-Frank Act requires the FSOC to take into consideration certain factors when making such a determination, including:

    (a) How leveraged the Covered Company is;

    (b) The "nature, scope, size, scale, concentration, interconnectedness, and mix of activities" of the Covered Company; and

    (c) The Covered Company's importance as a source of credit in the United States and as a source of liquidity to the U.S. financial system.

B. Once the FSOC has notified the Covered Company of its determination, the Covered Company would be required to "achieve and maintain" a 15-to-1 debt-to-equity ratio within 180 days after receipt of that notice.

1. The 15-to-1 debt-to-equity ratio would be calculated as the ratio of total liabilities to total equity capital minus goodwill.

2. For the purposes of the Proposed Rule, "debt" and "equity" have the same meaning as "total liabilities" and "total equity capital", respectively, as reported to the Federal Reserve on the applicable report for the Covered Company.

C. The Proposed Rule provides for the possibility of two 90-day extensions of the compliance deadline, upon application by a Covered Company and subject to the Federal Reserve's determination that:

1. Each such extension would be in the public interest; and

2. The Covered Company has made a good faith effort to comply with the requirement.

D. Although the Proposed Rule does not specify what actions a Covered Company would be expected to take to become compliant with the requirement, the preamble states that the Federal Reserve would expect that the Covered Company would do so in a manner consistent with its "safe and sound operation and the preservation of financial stability". The preamble also sets forth certain actions that a Covered Company might take to increase its equity capital in accordance with that standard before resorting to liquidating leveraged assets, such as:

1. Limits on distributions;

2. Conducting share offerings; or

3. Other capital raising efforts.

E. The debt-to-equity ratio requirement would end when the Covered Company is notified by the FSOC that the Covered Company no longer poses a grave threat to the financial stability of the United States.

Earlier versions of the Dodd-Frank Act contained proposals to apply a debt-to-equity limit to all Covered Companies.[53] The version that was signed into law included in Section 165(j) a debt-to-equity limit for only those institutions that the FSOC determines pose a "grave threat to the financial stability of the United States." Consequently, these provisions are likely, as a practical matter, to have limited application. Furthermore, it should be expected that the Federal Reserve would impose the early remediation framework on a stressed institution well before the "grave threat" standard would be met.

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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[53] Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1103(f)(3) (Dec. 11, 2009).

Appendix A

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**.

Proposed Rule Requirements	**Bank Holding Companies**	**Designated Non-Bank SIFIs**
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.
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.

[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.

Proposed Rule Requirements	Bank Holding Companies	Designated Non-Bank SIFIs
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**.

Appendix B

Items to Be Proposed in Future Rule-Makings

1. Scope Issues

   a. Framework for application of heightened standards to foreign banking organizations (FBOs)

   b. Savings and Loan Holding Companies (SLHCs)

      i. Risk-based capital and leverage requirements for SLHCs

      ii. Framework for application of heightened standards to SLHCs with "substantial banking activities"

   c. Potential rulemakings related to "supplemental standards" that were authorized, but not required, by the Dodd-Frank Act, including contingent capital, additional public disclosures and short-term debt limits.

2. Single-Counterparty Credit Limits

   a. Periodic reporting of credit exposures, together with the FDIC.

   b. Potential minimization of scope of the attribution rule.

   c. Potential alignment with international agreement on large exposure limits.

3. Risk-Based Capital and Leverage Requirements

   a. Implementation of Basel III capital standards, and any related revisions to current proposal.

   b. Capital surcharge rules for G-SIBs, as applicable to Covered Companies or a "subset" of Covered Companies.

4. Liquidity Requirements

   a. Implementation of Basel III liquidity standards, such as the Liquidity Coverage Ratio and the Net Stable Funding Ratio, and any related revisions to current proposal.

5. Risk Management and Risk Committee Requirements

   a. None identified.

6. Stress Testing Requirements

   a. Separate information/data collection proposal for supervisory stress testing.

   b. Methodology for supervisory stress tests.

   c. Specific data and report form for company-run stress testing.

7. Debt-to-Equity Limits

   a. None identified.

8. Early Remediation Framework

   a. Market indicators for the early remediation framework will be proposed annually under the rule, and the concept of using market indicators will generally be revisited by Federal Reserve "after gaining additional experience with the use of market data in the supervisory process."

   b. Future rule-makings in capital, liquidity and stress testing areas will impact early remediation triggers, and realignment should be expected in the early remediation rules.

Appendix C

Summary of Non-Market Indicator Triggers

	Level 1 (Heightened Supervisory Review)	Level 2 (Initial Remediation)	Level 3 (Recovery)	Level 4 (Recommended Resolution)
Tier 1 RBC, Total RBC, Tier 1 Leverage	Tier 1 > 6%, Total > 10%, or Leverage > 5% but weakness in capital structure or capital planning.	Fails to meet Level 1 capital requirements but has Tier 1 > 4%, Total > 8%, and Leverage > 4%.	Fails to meet Level 2 capital requirements but has Tier 1 > 3%, Total > 6%, or Leverage > 3%, OR Tier 1 < 6%, Total < 10%, Leverage < 5% for two consecutive complete quarters.	Tier 1 <3%, Total <6%, or Leverage <3%
Stress Test (under severely adverse scenario)	Capital ratios exceed minimum requirements but otherwise in noncompliance with the Federal Reserve's capital plan or stress testing rules.	Tier 1 Common < 5% during any quarter in the nine quarter planning horizon.	Tier 1 Common < 3% during any quarter in the nine quarter planning horizon.	Not applicable.
Enhanced Risk Management and Risk Committee Standards	Signs of weakness.	Multiple deficiencies.	Substantial noncompliance.	Not applicable.
Enhanced Liquidity Risk Management Standards[1]	Signs of weakness.	Multiple deficiencies.	Substantial noncompliance.	Not applicable.

[1] The early remediation framework does not include an express quantitative trigger for liquidity because the Federal Reserve stated that such a trigger could exacerbate funding pressures on the affected Covered Company.

Appendix D

Summary of Proposed Market Indicator Triggers

	Market Indicator	Description
Equity Based	**Expected Default Frequency (“EDF”)**	The expected probability of default in the next year by the Covered Company; calculated using Moody’s KMV RISKCALC model.
	Marginal Expected Shortfall (“MES”)	Expected loss on a Covered Company’s equity when overall market declines by a certain amount; calculated using the methodology described in *Measuring Systemic Risk.*[1]
	Market Equity Ratio (“MER”)	Ratio of a Covered Company’s market value of equity to its market value of equity plus its book value of debt.
	Option-Implied Volatility (“OIV”)	Implied volatility of out-of-the-money options on a Covered Company’s equity; calculated using standard option pricing models.
Debt Based	**Credit Default Swaps (“CDS”)**	The price of protection against default on a Covered Company’s 5-year unsecured senior bond.
	Subordinated Debt Spread (“Spread”)	The spread of the Covered Company’s subordinated bonds (with at least 5 years left to maturity) over the corresponding Treasury rate or LIBOR.

[1] Measuring Systemic Risk (2010, Acharay, Pederson, Phillipon and Richardson), available at http://vlab.stern.nyu.edu/welcome/risk.

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