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JANUARY 2, 2012

Federal Reserve Proposes Prudential Standards and Early Remediation

The Federal Reserve Board on Dec. 20 released its long-awaited proposal to implement key elements of the Dodd-Frank Act, including new standards for capital, stress testing, liquidity, single-counterparty credit exposure, risk management, and early remediation. While many bankers have made clear their concerns about the potential burdens of Dodd-Frank, the deliberate pace of the law's implementation has created its own aggravation, as the industry wearies of bracing for an impact that — a year and a half later — it still cannot adequately measure.

From that perspective, the Federal Reserve's proposal initially seemed only to add to the frustration. Large banks and nonbank financial companies anticipating new capital and liquidity requirements still do not know what their targets will be, as the Federal Reserve deferred a decision on capital surcharges until it implements the Basel Committee's capital framework.

While the Federal Reserve's failure to answer the big question on capital may tempt some readers to dismiss the importance of the proposal, beyond the high-profile deferral is a substantial strengthening of supervisory scrutiny in several areas of critical importance to banks and nonbank financial companies.

The Federal Reserve's proposed rule implementing Sections 165 and 166 of the Dodd-Frank Act¹ applies to U.S. bank holding companies with \$50 billion or more in assets and nonbank financial companies designated by the Financial Stability Oversight Council for Federal Reserve supervision² — taken together, the "covered companies" under the proposal. Standards for foreign banks will be proposed soon.³ What follows is a discussion of the salient points of the proposal.

¹ <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111220a1.pdf>

² The Federal Reserve acknowledged that application to nonbank companies, none of which have been designated yet, may require adjustments.

³ U.S.-based bank holding company subsidiaries of foreign banks relying on Supervision and Regulation Letter SR 01-01 would not need to comply with most provisions of the proposal until July 21, 2015. However, they would nevertheless need to comply with the liquidity and enterprise-wide risk management requirements and the debt-to-equity limit on the same timeframes as other bank holding companies.

KEY TAKEAWAYS

CAPITAL AND LEVERAGE REQUIREMENTS: First phase based on the Federal Reserve's capital plan rule issued in November; second phase on heightened quantitative standards in the Basel framework.

STRESS TESTING: Spells out annual supervisory stress test requirements for very large financial companies, as well as requirements for internal stress tests required of bank holding companies with more than \$10 billion of assets.

LIQUIDITY: Expands and incorporates in regulation banking agencies' risk management standards; heightened quantitative standards will likely be based on the Basel framework.

SINGLE-COUNTERPARTY CREDIT LIMITS: Beyond the 25 percent of capital limit required by Dodd-Frank, FSOC-designated nonbanks and bank holding companies with more than \$500 billion face a 10 percent limit on exposures to each other and to similarly large foreign banks.

RISK MANAGEMENT: Incorporates in regulation longstanding supervisory priorities, including an enterprise-wide risk management structure and clear board and management responsibilities.

EARLY REMEDIATION FRAMEWORK: Includes forward-looking triggers based on stress tests, market indicators, and perceived risk management weaknesses. Restricts growth and capital distributions for banks not "well-capitalized."

EFFECTIVENESS Covered companies must comply with most requirements one year from the effective date of the final rules. However, there are different transition arrangements for the capital and leverage requirements, single-counterparty credit limits, and stress testing requirements.

CAPITAL AND LEVERAGE REQUIREMENTS

The proposal sets forth a two-stage approach to implementing the heightened capital standards of Section 165 of Dodd-Frank. In the first stage, covered companies would have to comply with existing capital requirements, including those spelled out in the Federal Reserve's capital-planning rule issued in November — under which large bank holding companies must submit board-approved capital plans every year to the Federal Reserve and obtain Federal Reserve approval before making certain capital distributions.⁴ In the second stage, all or a subset of covered companies would have to comply with the forthcoming Basel III capital frameworks and G-SIB surcharge, and follow their phase-in schedule.

Under the capital planning rule, covered companies must demonstrate how they will maintain a tier 1 common ratio of at least 5 percent (calculated under existing capital rules) under expected

⁴ See <http://www.federalreserve.gov/newsevents/press/bcreg/20111122a.htm>

and stressed scenarios. Stress testing, discussed further below, is required under both the capital planning rule and Section 165.

For the second stage of implementing the heightened capital standards, the Federal Reserve is working with the other U.S. banking regulators to implement the Basel III capital reforms⁵ in the United States. In addition, the Federal Reserve will propose a surcharge in conjunction with the Basel Committee's G-SIB surcharge framework announced on November 4, 2011.⁶ That framework imposes an additional tier 1 common equity buffer⁷ of between 1 percent and 3.5 percent of risk-weighted assets, depending on global systemic importance.

Most U.S. bank holding companies with greater than \$50 billion of assets are not G-SIBs (of the 29 G-SIBs the Basel Committee initially identified, eight are domiciled in the United States⁸), leaving open the question of whether the Federal Reserve intends to apply a surcharge to a broader group of companies. It is also not clear how broadly the banking agencies will apply the Basel III reforms, which also significantly raise capital standards.

While industry participants expecting bright lines on heightened capital standards are bound to be disappointed by the proposal, they in fact would have much to implement under it. While largely qualitative, the proposed standards are complex, and taken together with the recent capital planning rule, raise the bar on risk management and capital planning. The proposal requires bank holding companies to demonstrate that they can withstand severe stress and still meet a 5 percent tier 1 minimum, and also demonstrate that they are well on their way to meeting the Basel III standards. The Federal Reserve's past actions have made it clear that it will not hesitate to require holding companies to conserve capital if it isn't satisfied with the results and rigor of a company's stress testing and capital planning.

STRESS TESTING

Supervisory Stress Tests

The proposal would implement Dodd-Frank's requirement that the Federal Reserve conduct annual stress tests on covered companies and publish a summary of the results of those tests. The purpose of these supervisory stress tests is to evaluate the potential impact of stress on each covered company's capital adequacy and financial condition over a horizon of at least nine quarters. As with the capital requirements, the process is designed to work in tandem with the Federal Reserve's recently issued capital plan rule⁹ requiring an annual submission of a capital plan by covered companies. The Federal Reserve would evaluate a covered company's capital adequacy based on the supervisory stress tests and the capital plan, which would incorporate a company's own internal stress tests (see below).

Covered companies would submit quarterly and annual data for the supervisory stress tests as spelled out in a future published notice and comment. As required under Dodd-Frank, the Federal

⁵ <http://www.bis.org/publ/bcbs189.pdf>

⁶ See <http://www.bis.org/publ/bcbs207.htm>

⁷ The G-SIB surcharge will be an add-on to the Basel III capital conservation buffer. Institutions that fail to maintain the full buffer will be subject to restrictions on capital distributions.

⁸ The Basel Committee has indicated that the list will be reevaluated each year.

⁹ See 12 CFR 225.8. For the upcoming 2012 supervisory stress tests, the Federal Reserve is taking a hybrid approach to covered companies. The 19 bank holding companies that participated in the previous Federal-Reserve-conducted stress tests (Comprehensive Capital Analysis and Review, or CCAR) will be expected to provide more comprehensive data (see approved information collection at 76 FR 73634), while the covered companies that were not part of the earlier stress tests will provide less information. The Federal Reserve will only publish the results of the 19 CCAR bank holding companies in the upcoming stress tests.

Reserve would evaluate the ability of a covered company to absorb losses under baseline, adverse, and severely adverse scenarios, with specific scenarios published by the Federal Reserve prior to conducting each annual supervisory stress test.

The Federal Reserve would then publish a high-level summary of supervisory stress test results for each covered company no later than mid-April each year. Results would cover each quarter-end over a nine-quarter horizon with estimates on:

- Losses, including overall losses by sub-portfolio, available-for-sale and held-to-maturity securities, trading portfolios, and counterparty exposures
- Pre-provision net revenue
- Allowance for loan losses
- Pro forma regulatory and other capital ratios.

The timing of the supervisory stress test cycle is overlaid with the company-run stress tests in a timeline below.

Company-run Stress Tests

Dodd-Frank also required covered companies and “\$10 billion companies”¹⁰ to conduct their own stress tests on a semiannual or annual basis, respectively. One of the two yearly stress tests of covered companies — and the annual stress test required of \$10 billion companies — would be conducted in parallel with the supervisory stress tests.

The Federal Reserve would publish required scenarios by mid-November, with the tests conducted (and results submitted) by the following January 5.¹¹ The scenarios provided by the Federal Reserve would be the same as the scenarios used for the supervisory stress tests. For their other annual stress tests, covered companies would develop their own scenarios, reflecting baseline, adverse, and severely adverse conditions, the results of which would be reported by July 5 of each year.

Though the Federal Reserve will publish the specific requirements prior to each test, the proposal indicates that the required results are likely to include:

- Qualitative information, including but not limited to:
 - How the company uses the stress tests in internal decision-making
 - The types of risks covered
 - A description of the methodology
 - Assumptions about future capital distributions
- Quantitative information, including but not limited to estimates of:
 - Pro forma capital levels and ratios, including regulatory ratios
 - Losses by exposure category
 - Pre-provision net revenue
 - Allowance for loan losses
 - Total assets and risk-weighted assets
 - Aggregate loan balances
 - Future capital distributions

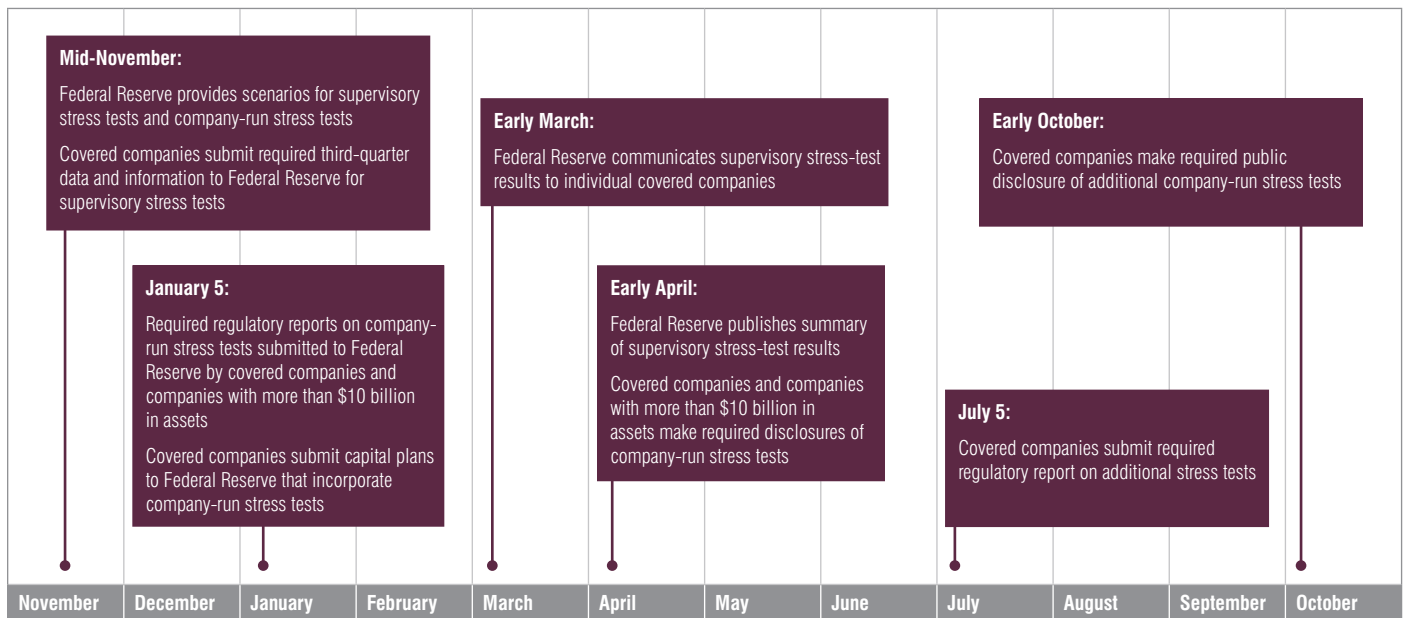
¹⁰ The proposal defines “\$10 billion company” as any bank holding company, savings and loan holding company, or state member bank with more than \$10 billion in consolidated assets. If multiple entities within a holding company structure meet this definition, the Federal Reserve will coordinate with other federal financial regulatory agencies as appropriate.

¹¹ The proposal states that these dates are illustrative, but presumably the specific dates would be close to these, and sync with the supervisory stress test dates.

The Federal Reserve would then review the reports, analyze the quality of each company's stress test processes, and provide feedback through the supervisory process. Companies would integrate their stress test results, and any supervisory feedback, into their capital plan and structure, resolution plans, and risk management processes. In addition, companies would publish a summary of the results of their internal stress tests within 90 days of submitting each required supervisory report. Disclosures would include a description of methodologies employed and the risks included, as well as the estimated impact — over the 9-quarter horizon under each of the three scenarios — on losses, allowance for loan losses, net income, and capital levels and ratios.

SUPERVISORY STRESS TESTS AND COMPANY-RUN STRESS TESTS ANNUAL CYCLE

KEY DATES



The proposal emphasizes that although these stress tests focus on the impact of adverse scenarios on capital, the Federal Reserve expects each company to have a broader stress-testing program that includes assessing the impact of adverse scenarios on other risks.

LIQUIDITY REQUIREMENTS

The proposal also includes heightened liquidity standards as mandated under Section 165 of the Dodd-Frank Act. For covered companies, the liquidity-risk management standards contained in the Interagency Policy Statement on Funding and Liquidity Risk Management issued in March 2010 would be expanded upon and converted to binding requirements.¹² For example, the proposed rule would require covered companies to conduct monthly stress tests with overnight, 30-day, 90-day, and 1-year horizons, as well as maintain a buffer of highly liquid, unencumbered assets¹³ sufficient to meet 30-day funding needs over a range of stress scenarios.

¹² See <http://www.federalreserve.gov/boarddocs/srletters/2010/sr1006.htm>.

¹³ Under the proposed rule, "highly liquid assets" include: cash; securities issued or guaranteed by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity; and any other assets that, in the Federal Reserve's opinion, meet specific criteria enumerated in the proposed rule.

The proposed rule would also impose requirements on:

- Corporate governance for managing liquidity risk
- Comprehensive cash-flow projections
- Establishing internal liquidity-risk limits
- Liquidity-risk monitoring and documentation
- Contingency-funding plans

As with the capital and leverage elements of the proposed rule, the Federal Reserve deferred promulgation of quantitative requirements to future rulemakings. Specifically, the Federal Reserve intends to institute a liquidity coverage ratio¹⁴ and a net stable funding ratio¹⁵ for covered companies that are consistent with Basel III — though it is not yet clear whether it will apply these quantitative requirements to all covered companies or a subset. These ratios are currently in a Basel Committee observation period, and are scheduled for national implementation by 2015 for the LCR and 2018 for the NSFR. The proposal asked whether the Federal Reserve should adopt a short-term debt limit — authorized but not required under Section 165 — to supplement or replace the ratios.

SINGLE-COUNTERPARTY CREDIT LIMITS

As required by the statute, the proposed rule imposes a general limit of 25 percent of capital stock and surplus on aggregate net credit exposures of covered companies to unaffiliated counterparties. A more stringent 10 percent limit would be applied to certain very large financial companies — generally, those with \$500 billion of assets or above.

	SCOPE	COUNTERPARTY
25% GENERAL LIMIT	Covered companies	Most counterparties, including foreign sovereigns and foreign banks
10% MORE STRINGENT LIMIT	“Major covered companies” – i.e., bank holding companies with \$500 billion or more in assets, as well as nonbank SIFIs	Major covered companies and foreign banks with \$500 billion or more in global assets

The proposal specifies calculations of gross and net credit exposures; trading and available-for-sale debt securities, for instance, are valued at the greater of amortized purchase price or market value to limit the ability of a covered company to provide additional funding to a faltering counterparty.

Gross credit exposures would be netted against eligible guarantees, credit and equity derivatives, hedges, or other relevant instruments to determine net exposure, but protection from those instruments would be included in gross credit exposure to the protection provider. For example, if a covered company made a \$100 loan to a counterparty and received a \$70 guarantee, it would have a \$30 net credit exposure to the original counterparty and a \$70 gross credit exposure to the protection provider.

¹⁴ The LCR ensures that firms have sufficient high quality liquid resources to survive an acute 30-day stress scenario.

¹⁵ The NSFR ensures that firms have sufficient medium- and long-term funding sources to support their liabilities over a 1-year horizon. It is designed to limit structural asset-liability maturity mismatches.

Although the proposal does not exempt sovereign debt — an issue of particular importance given the current European crisis — it does exempt direct claims on the U.S. (though not state or local governments), including Fannie Mae and Freddie Mac, as well as intraday credit exposures.

Companies subject to credit limits must comply daily and submit monthly reports. Though the Federal Reserve and FDIC are still finalizing reporting requirements, the Federal Reserve would not pursue enforcement if the company returned to compliance within a 90-day grace period. It could also adjust limits temporarily if, for instance, there were a decrease in the company's capital stock and surplus, or covered companies or unaffiliated counterparties merged.

The overall impact of these credit limits — particularly the more stringent 10 percent limit — is unknown. While these limits appear to impose constraints on interbank markets, the frequent use of cash collateral — as well as companies' internal limits — may dramatically mitigate their actual impact. In any event, institutions should review the specific rules for calculating gross and net credit exposure carefully, conduct their own analyses, and be prepared to comment if necessary.

RISK MANAGEMENT

The proposal contains significant risk management requirements that implement provisions of Dodd-Frank and incorporate long-standing risk management supervisory priorities into regulation. The Federal Reserve notes that the standards, which mandate an enterprise-wide risk management structure with clear accountabilities for the board and management, help to address the risk management failures that became evident during the recent banking crisis.

Covered companies and publicly traded bank holding companies with more than \$10 billion in assets would be required to have board risk committees with prescribed responsibilities. The risk committee must be chaired by an independent director, and have at least one member with risk management expertise commensurate with the company's business and risk profile; all members must have a general understanding of risk management and its application. For covered companies, the risk committee must be a stand-alone committee rather than one combined with another committee.

RISK COMMITTEE REQUIREMENTS	
Risk committees would review and approve enterprise-wide risk management frameworks with the following elements:	
	<ul style="list-style-type: none">• Risk limits appropriate to each business line
	<ul style="list-style-type: none">• Policies and procedures relating to risk management governance and practices, as well as to control infrastructure
	<ul style="list-style-type: none">• Processes for identifying risks, including emerging risks
	<ul style="list-style-type: none">• Monitoring compliance with the risk-limit structure and risk management framework
	<ul style="list-style-type: none">• Implementation of corrective actions
	<ul style="list-style-type: none">• Appropriate delegation of authority and independence
	<ul style="list-style-type: none">• Integration of risk management objectives in the compensation structure

Covered companies would also be required to have a chief risk officer reporting to the risk committee and the CEO, and compensated to support objectivity in risk evaluation. Under the proposal, the CRO would possess risk management expertise appropriate to the company's specific business model.

CRO RESPONSIBILITIES	
A chief risk officer would be appointed with the following enterprise-wide responsibilities:	
	<ul style="list-style-type: none"> • Allocating and monitoring compliance with risk limits
	<ul style="list-style-type: none"> • Establishing policies and procedures relating to risk management governance, practices, and controls
	<ul style="list-style-type: none"> • Developing processes for identifying and reporting risks
	<ul style="list-style-type: none"> • Managing risk exposures and risk controls
	<ul style="list-style-type: none"> • Monitoring and testing risk controls
	<ul style="list-style-type: none"> • Reporting risk management issues and emerging risks
	<ul style="list-style-type: none"> • Ensuring effective resolution of risk management issues

By elevating these risk management standards into regulations, coupled with reflecting them in the early remediation framework described below, the Federal Reserve is sending a clear signal as to the urgency it ascribes to them. Once finalized, covered companies should waste no time in evaluating their own systems and processes against these expectations.

EARLY REMEDIATION FRAMEWORK

The proposal also puts forth a remedial framework of increasing stringency for covered companies, as required by Section 166 of Dodd-Frank. Unlike the prompt corrective action regime for banks, the early-remediation framework established in the proposal includes forward-looking triggers based on risk management, stress tests and market indicators, as well as triggers based on regulatory capital ratios.

Although the early-remediation framework largely incorporates the specific regulatory capital ratios of the PCA regime, it is more aggressive in some respects. In particular, it imposes mandatory restrictions on growth and capital distributions for covered companies that are not "well-capitalized." The current PCA regime does not compel similar regulatory action until a depository institution falls below "adequately capitalized." Similarly, the Federal Reserve will consider recommending the resolution of a covered company that mirrors the PCA "significantly undercapitalized" category, while the PCA regime would not compel resolution until an institution is "critically undercapitalized."

The framework is also subjective in some respects, because it relies upon qualitative triggers such as signs of weakness, multiple deficiencies, and substantial noncompliance in meeting enhanced risk management standards. However, given that these standards would already be regulatory requirements under the proposal, hard-wiring them into the early remediation regime strongly suggests that the Federal Reserve will enforce them rigorously and give minimal leeway to covered companies in meeting the standards. The triggers and remediation actions are summarized below.

EARLY REMEDIATION TRIGG

	LEVEL 1 (HEIGHTENED SUPERVISORY REVIEW (HSR))	LEVEL 2 (INITIAL REMEDIATION)	LEVEL 3 (RECOVERY)	LEVEL 4 (RECOMMENDED RESOLUTION)
RISK-BASED CAPITAL/LEVERAGE	Meets all risk-based and leverage requirements for a well capitalized covered company: Tier 1 RBC ratio > 6.0% Total RBC ratio > 10.0% Tier 1 Leverage ratio > 5.0% However, the covered company has demonstrated capital structure or capital planning weaknesses.	Fails to meet any one of the Level 1 capital levels and maintains: Tier 1 RBC ratio > 4.0% Total RBC ratio > 8.0% Tier 1 Leverage ratio > 4.0%	Fails to meet any one of the Level 2 capital levels and maintains: Tier 1 RBC ratio > 3.0% Total RBC ratio > 6.0% Tier 1 Leverage ratio > 3.0% Or institution's risk-based capital ratios remain below 6.0% Tier 1 RBC, 10.0% Total RBC, or 5.0% Leverage, for more than two complete consecutive calendar quarters.	Covered company's regulatory capital ratios are below any of the following thresholds: 3.0% Tier 1 RBC 6.0% Total RBC 3.0% Tier 1 Leverage ratio
STRESS TESTS	Covered company's regulatory capital ratios exceed minimum requirements under the supervisory stress test severely adverse scenario but it is otherwise in noncompliance with the Federal Reserve's capital plan or stress testing rules.	Under the supervisory stress test severely adverse scenario, the company's Tier 1 common RBC ratio falls below 5% during any quarter of the nine-quarter planning horizon.	Under the severely adverse scenario, the covered company's Tier 1 common RBC ratio falls below 3% during any quarter of the nine-quarter planning horizon.	N/A
ENHANCED RISK MANAGEMENT AND RISK COMMITTEE STANDARDS	Covered company has manifested signs of weakness in meeting enhanced risk management or risk committee requirements for covered companies.	Covered company has demonstrated multiple deficiencies in meeting the enhanced liquidity risk management standards for covered companies.	Covered company is in substantial noncompliance with enhanced risk management and risk committee requirements for covered companies.	N/A
ENHANCED LIQUIDITY RISK MANAGEMENT STANDARDS	Covered company has manifested signs of weakness in meeting the enhanced liquidity risk management standards for covered companies.	Covered company has demonstrated multiple deficiencies in meeting the enhanced liquidity risk management standards for covered companies.	Covered company is in substantial noncompliance with enhanced liquidity risk management standards for covered companies.	N/A
MARKET INDICATORS	The median value of any of the covered company's market indicators exceeds the trigger threshold for the entire breach period.	N/A	N/A	N/A

REMEDATION ACTIONS

LEVEL 1 (HEIGHTENED SUPERVISORY REVIEW (HSR))	LEVEL 2 (INITIAL REMEDIATION)	LEVEL 3 (RECOVERY)	LEVEL 4 (RECOMMENDED RESOLUTION)
<p>Heightened Supervisory Review (HSR): The Federal Reserve will produce an internal report on the elements evidencing deterioration within 30 days of a Level 1 trigger breach and determine whether the institution should be elevated to a higher level of remediation.</p>	<p>All capital distributions (e.g., dividends and buybacks) are restricted to no more than 50% of the average of the covered company's net income in the previous two quarters.</p> <p>Covered company faces restrictions on growth (no more than 5% growth in total assets or total RWA per quarter or per annum), and is generally prohibited from directly or indirectly acquiring controlling interest in any company.</p> <p>Covered company will be subject to a non-public MOU.</p> <p>Covered company may be subject to other limitations and conditions on its conduct or activities as the Federal Reserve deems appropriate.</p>	<p>Covered company is placed under a written agreement that prohibits all capital distributions, any quarterly growth of total assets or RWA, and material acquisitions. The written agreement will also include a requirement to raise additional capital to restore the covered company's capital level to or above regulatory minimums. If written agreement timeframes are not met, the covered company may be subject to divestiture requirements.</p> <p>Covered company will also be subject to a prohibition on discretionary bonus payments and restrictions on pay increases.</p> <p>Supervisors may also remove culpable senior management and limit transactions between affiliates.</p> <p>Covered company may be subject to other limitations and conditions on its conduct or activities as the Federal Reserve deems appropriate.</p>	<p>The Federal Reserve will consider whether to recommend to the Treasury Department and the FDIC that the covered company be resolved under the orderly liquidation authority provided for in Title II of the Dodd-Frank Act.</p>

The Federal Reserve stated that once it implements the Basel III revised capital standards and the capital surcharge framework, it may propose additional changes to the early-remediation framework to align more closely with the revised capital standards.

Institutions likely to be affected by this proposal should review it carefully and consider submitting comments. The Federal Reserve will accept comments until March 31, 2012.

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