FS Regulatory Brief

The Federal Reserve's proposal to implement enhanced prudential standards for large bank holding companies

Background on enhanced prudential standards for SIFIs – a measured approach

On Tuesday, December 20, 2011, the Federal Reserve Board (FRB) issued a proposal to implement Sections 165 and 166 of the Dodd-Frank Act (Dodd-Frank or the Act). In speeches and testimony, the FRB had indicated that it viewed these provisions as imposing a "package of enhanced prudential standards" on bank holding companies (BHCs) with total consolidated assets of $50 billion or more and on nonbank financial companies (NBFCs) that the Financial Stability Oversight Council (Council) has designated for supervision by the FRB (together, "covered companies" and each a "covered company").

Early rumor had it that this package of regulatory proposals would run to a thousand pages or more and would greatly add to the regulatory burdens on large complex BHCs, which have been the subject directly or indirectly of most Dodd-Frank related rule-makings. Perhaps moved by the Holiday Season, the FRB's proposal is "only" 173 pages in length (the Volcker proposal is almost twice as long). More important than reasonable volume is the proposal's gradual or phased-in approach to implementation. Substantively, in several areas, the proposal, as an initial phase, uses or enhances requirements already imposed or to be imposed on large BHCs – for example, the first phase of enhanced risk-based capital and leverage requirements is compliance with the FRB's capital plan rule issued in November 2011. Later implementation phases are typically to be addressed by the FRB in subsequent rule-makings. Also the FRB in many areas has sought to appropriately sequence the standards with other requirements.

In addition, to mitigate burdens on coming into compliance with the new rules, the FRB is proposing to provide meaningful phase-in periods, which will differ somewhat by area of regulation. And rather than try to sort out in its initial proposal the treatment of foreign bank SIFIs and Savings & Loan Holding Companies (SLHCs), the FRB puts these matters into separate later rule-makings to be issued at a later date. And while the proposal covers NBFCs, the FRB recognizes that its treatment of NBFCs may differ by type of business under flexibility granted the FRB and the Council, and avoids speculating on what that may look like when no NBFC has yet to be designated.

Comments are due on the proposal by March 31, 2012.

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Overview – implementing what is required

The proposal includes rules to implement the requirements under section 165 related to (i) risk-based capital and leverage; (ii) liquidity; (iii) single-counterparty credit limits; (iv) overall risk management and risk committees; (v) stress tests; and (vi) a debt-to-equity limit for covered companies that the Council has determined pose a grave threat to financial stability. The proposal also includes rules to implement the early remediation requirements in section 166 of the Act related to establishing measures of financial condition and remediation requirements that increase in stringency as the financial condition of a covered company declines. The FRB stresses that the proposal provides a core set of concrete rules to complement the FRB's existing efforts to enhance the supervisory framework for covered companies.

Section 165(d) of the Act also establishes requirements that each covered company submit periodically to the FRB and Federal Deposit Insurance Corporation (FDIC) a plan for rapid and orderly resolution under the Bankruptcy Code in the event of its material financial distress or failure, as well as a periodic report regarding credit exposures between each covered company and other significant financial companies. The FRB and FDIC jointly issued a final rule to implement the resolution plan requirement that became effective on November 30, 2011 and expect to implement periodic reporting of credit exposures at a later date.

In addition to the required standards, the Act authorizes but does not require the FRB to establish additional enhanced standards for covered companies relating to (i) contingent capital; (ii) public disclosures; (iii) short-term debt limits; and (iv) such other prudential standards as the FRB determines appropriate. The FRB is not proposing any of these supplemental standards at this time but indicates it continues to consider whether adopting any of these standards would be appropriate.

Applicability of the proposal

Large US BHCs and designated NBFCs

The current proposal would apply only to US-based BHCs that are covered companies and to NBFCs, and would not apply to foreign banking organizations. The Act requires the enhanced standards established by the FRB for covered companies under section 165 to be more stringent than those standards applicable to other BHCs and NBFCs that do not present similar risks to US financial stability. Section 165 also requires that the enhanced standards established pursuant to that section increase in stringency based on the systemic footprint and risk characteristics of individual covered companies.

This proposal would apply the same set of enhanced prudential standards to covered companies that are BHCs and covered companies that are NBFCs. However, in applying the enhanced prudential standards to covered companies, the FRB may determine, on its own or in response to a recommendation by the Council, to tailor the application of the enhanced standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the FRB deems appropriate.

The FRB notes that this authority to tailor application will be particularly important in applying the enhanced standards to specific NBFCs designated by the Council that are organized and operated differently from banking organizations. The types of business models, capital structures, and risk profiles of companies that would be subject to designation by the Council could vary significantly. While this proposal was largely developed with large, complex BHCs in mind, the FRB believes that some of the standards nonetheless provide sufficient flexibility to be readily implemented by covered companies that are not BHCs. In prescribing prudential standards under section 165(b)(1), the FRB would to take into account these differences. Following designation of NBFCs by the Council, the FRB also would consider the appropriate risk-based capital treatment of asset types with no explicit treatment under the current risk-based capital rules.

Foreign banking organizations

Foreign banking organizations that have US banking operations (whether a US branch, a US agency, or a US subsidiary bank holding company or bank) and have global total consolidated assets of $50 billion or more are subject to sections 165 and 166 of the Act. Section 165 instructs the FRB, in applying the enhanced prudential standards of section 165 to foreign financial companies, to give due regard to the principle of national treatment and equality of competitive opportunity, and to take into account the extent to which the foreign company is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the United States.

To quote the proposal, "[d]etermining how to apply the enhanced prudential standards and early remediation framework established by the Act to foreign banking organizations in a manner consistent with the purposes of the statute and the FRB's existing framework of supervising foreign banking organizations is difficult." The proposal notes that the scope of enhanced prudential standards required under sections 165 and 166 extends "beyond the set of prudential standards that are part of existing international agreements," and foreign banking organizations are subject to home country regulatory and supervisory regimes that employ a wide variety of approaches to prudential regulation. Further, foreign banking organizations operate in the United States through diverse structures, complicating the consistent application of the enhanced standards to the US operations of a foreign banking organization. Finally, the risk posed to US financial stability by foreign banking organizations that are subject to sections 165 and 166 varies widely. Accordingly, the FRB states that it is "actively developing a proposed framework for applying the Act's enhanced prudential standards and early remediation requirement to foreign banking organizations, and expects to issue this framework for public comment shortly."

However, the definition of "covered company" for purposes of the proposal would nonetheless include a foreign banking organization's US-based bank holding company subsidiary that on its own has total consolidated assets of $50 billion or more. With the exception of the proposed liquidity and enterprise-wide risk management requirements and the debt-to equity limit for covered companies that the Council has determined pose a grave threat, the proposed rule would not apply to any bank holding company subsidiary of a foreign banking organization that has relied on Supervision and Regulation Letter SR 01–01 issued by the FRB (as in effect on May 19, 2010) until July 21, 2015). This proposal would not in any event extend to the US operations of a foreign banking organization that are conducted outside of a US-based BHC subsidiary.

Savings & loan holding companies

While sections 165 and 166 generally do not apply to SLHCs, section 165(i)(2) requires the FRB to issue regulations pursuant to which any "financial company" for which the FRB is the primary federal financial regulatory agency and that has more than $10 billion in total consolidated assets must conduct an annual stress test Thus, the proposal would apply annual company-run stress test requirements to any SLHC with more than $10 billion in consolidated assets. However, because the annual stress test requirement, as proposed, is predicated on a company being subject to consolidated capital requirements, this proposal would delay the effective date of the company- run stress test requirements for SLHCs until the FRB has established risk-based capital requirements for SLHCs in 2015.

While the remaining parts of section 165 and section 166 do not specifically apply to SLHCs, the FRB, as the primary supervisor of SLHCs, has the authority under the Home Owners' Loan Act to apply the enhanced standards to SLHCs to ensure their safety and soundness. The FRB intends to issue a separate proposal for notice and comment to initially apply the enhanced standards and early remediation requirements to all SLHCs with substantial banking activities—i.e., any SLHC that (i) has total consolidated assets of $50 billion or more; and (ii)(A) has savings association subsidiaries which comprise 25 percent or more of such SLHC's total consolidated assets, or (B) controls one or more savings associations with total consolidated assets of $50 billion or more.

As is the case with stress testing, many of the other enhanced standards are predicated on a covered company being subject to consolidated capital requirements. Therefore, similar to the approach with respect to applying the annual company-run stress test requirement to SLHCs, the FRB intends to apply enhanced prudential standards and early remediation requirements on SLHCs with substantial banking activities once the FRB has established risk-based capital requirements for SLHCs.

Enhanced prudential standards

Risk-based capital requirements and leverage limits

Section 165(b)(1)(A)(i) of the Act directs the FRB to establish enhanced risk-based capital and leverage standards for covered companies. The FRB plans to meet this statutory requirement with a two-part effort.

First, under this proposal, the FRB would subject all covered companies to the FRB's capital plan rule, which currently requires all BHCs with $50 billion or more in consolidated assets to submit an annual capital plan to the FRB for review (capital plan rule). Under the capital plan rule, covered companies would have to demonstrate to the FRB that they have robust, forward-looking capital planning processes that account for their unique risks and that permit continued operations during times of economic and financial stress. The supervisory and company-run stress tests that are part of this proposal and discussed below are important aspects of this forward-looking process. The results of those stress tests, as well as the annual supervisory stress test conducted by the FRB under section 165(i)(1) of the Dodd-Frank, will be considered in the evaluation of a covered company's capital plan.

Under the capital plan rule, covered companies would be required to demonstrate to the FRB their ability to maintain capital above existing minimum regulatory capital ratios and above a tier 1 common ratio of 5 percent under both expected and stressed conditions over a minimum nine-quarter planning horizon. Covered companies with unsatisfactory capital plans would face limits on their ability to make capital distributions.

Secondly, the FRB intends to supplement the enhanced risk-based capital and leverage requirements included in this proposal with a subsequent proposal to implement a quantitative risk-based capital surcharge for covered companies or a subset of covered companies. The FRB notes that it is working with the other US banking regulators to implement the Basel III capital reforms in the United States. Building on the Basel III reforms, the Basel Committee on Banking Supervision (BCBS) published a document in November 2011 which set forth an additional capital requirements for Global Systemically Important Banks (G-SIBs).The FRB intends to propose a quantitative risk-based capital surcharge in the United States based on the BCBS approach consistent with the BCBS's implementation timeframe. The forthcoming proposal would contemplate adopting implementing rules in 2014, and requiring G-SIBs to meet the capital surcharges on a phased-in basis from 2016-2019.

Liquidity requirements

The FRB intends to implement enhanced liquidity requirement through a multi-stage approach. This proposal would subject covered companies to a set of enhanced liquidity risk management standards, including liquidity stress testing. The proposal builds on guidance previously adopted by the FRB and other US federal banking agencies and proposes higher liquidity risk management standards for covered companies.

In particular, the proposal would require covered companies to conduct internal stress tests at least monthly to measure their liquidity needs at 30-day, 90-day and one-year intervals during times of instability in the financial markets and to hold liquid assets that would be sufficient to cover 30-day stressed net cash outflows under their internal stress scenarios. Covered companies also would be required to meet specified corporate governance requirements around liquidity risk management, to project cash flow needs over various time horizons, to establish internal limits on certain liquidity metrics, and to maintain a contingency funding plan (CFP) that identifies potential sources of liquidity strain and alternative sources of funding when usual sources of liquidity are unavailable.

In addition to the enhanced liquidity risk management standards included in this proposal, the FRB and other US federal banking agencies have been working with the BCBS over the past few years to develop quantitative liquidity requirements to increase the capacity of internationally active banking firms to absorb shocks to funding relative to the liquidity risks they face. The BCBS approved two new liquidity rules as part of the Basel III reforms in December 2010. The first rule is a Liquidity Coverage Ratio (LCR), which would require banks to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows over a 30-day time horizon under a supervisory stress scenario. The second rule is the Net Stable Funding Ratio (NSFR), which would require banks to enhance their liquidity risk resiliency out to one year. Under the terms of Basel III, global banks are required to comply with the LCR by 2015 and with the NSFR by 2018.

The FRB notes that the Basel III liquidity rules are currently in an international observation period as the US federal banking agencies and other BCBS members assess the potential impact of the rules on banks and various financial markets. The FRB intends, in conjunction with other federal banking agencies, to implement these standards in the United States through one or more separate rulemakings. Through implementation of these standards in the United States, the FRB anticipates that the Basel III liquidity rules would then become a central component of the enhanced liquidity requirements for covered companies, or a subset of covered companies, under section 165 of the Act.

Single-counterparty credit limits

In an effort to address concentration risk among large financial institutions, section 165(e) of the Act directs the FRB to establish single-counterparty credit limits for covered companies in order to limit the risks that the failure of any individual company could pose to a covered company. This section directs the FRB to prescribe regulations that prohibit covered companies from having credit exposure to any unaffiliated company that exceeds 25 percent of the capital stock and surplus of the covered company. This section also authorizes the FRB to lower the 25 percent threshold if necessary to mitigate risks to the financial stability of the United States.

Credit exposure to a company is defined broadly in section 165(e) of the Act to cover all extensions of credit to the company; all repurchase and reverse repurchase agreements, and securities borrowing and lending transactions, with the company; all guarantees and letters of credit issued on behalf of the company; all investments in securities issued by the company; counterparty credit exposure to the company in connection with derivative transactions; and any other similar transaction that the FRB determines to be a credit exposure for purposes of section 165(e). Section 165(e) also grants authority to the FRB to exempt transactions from the definition of the term “credit exposure” if the FRB finds that the exemption is in the public interest and consistent with the purposes of the subsection.

The proposal implements these statutory provisions by defining key terms, such as covered company, unaffiliated counterparty, and capital stock and surplus. The proposal also targets the mutual interconnectedness of the largest financial companies by setting a stricter 10 percent limit for credit exposure between a covered company and a counterparty that each either have more than $500 billion in total consolidated assets or are a nonbank covered company.

In addition, the proposal provides rules for measuring the amount of credit exposure generated by the various types of credit transactions. Notably, the proposal would allow covered companies to reduce their credit exposure to a counterparty for purposes of the limit by obtaining credit risk mitigants such as collateral, guarantees, and credit derivative hedges. The proposal describes the types of collateral, guarantees and derivative hedges that are eligible under the rule and provides valuation rules for reflecting such credit risk mitigants.

Risk management and risk committee requirements

The FRB states that sound, enterprise-wide risk management by covered companies reduces the likelihood of their material distress or failure and thus promotes financial stability. In addition to adopting enhanced risk management standards for covered companies, the FRB is directed by section165 (h) to require publicly traded covered companies and publicly traded BHCs with $10 billion or more in total consolidated assets to establish a risk committee of the FRB of directors that is responsible for oversight of enterprise-wide risk management, is comprised of an appropriate number of independent directors, and includes at least one risk management expert.

The proposal would require all covered companies to implement robust enterprise-wide risk management practices that are overseen by a risk committee of the Board of directors and chief risk officer with appropriate levels of independence, expertise and stature. The proposal also would require any publicly traded BHC with $10 billion or more in total consolidated assets and that is not a covered company to establish a risk committee.

Stress testing requirements

Section 165(i)(1) directs the FRB to implement rules requiring the FRB, in coordination with the appropriate primary Federal regulatory agencies and the Federal Insurance Office, to conduct an annual evaluation of whether each covered company has sufficient capital to absorb losses as a result of adverse economic conditions (supervisory stress tests). The FRB is also required to publish a summary of the results of the supervisory stress tests.

In addition, section 165(i)(2) directs the FRB to implement rules requiring each covered company to conduct its own semi-annual stress tests and any state member bank, BHC or SLHC with more than $10 billion in total consolidated assets (that is not a covered company) to conduct its own annual stress tests (company-run stress tests). Companies must also publish a summary of the results of the company-run stress tests.

The proposal would implement these statutory provisions by requiring the FRB to conduct annual supervisory stress tests of covered companies under baseline, adverse, and severely adverse scenarios and by requiring companies that are subject to company-run stress test requirements to conduct their own capital adequacy stress tests on an annual or semiannual basis, as applicable. Under the proposal, the FRB would publicly disclose information on the company-specific results of the supervisory stress tests.

Debt-to-equity limits for certain covered companies

Section 165(j) of the Act provides that the FRB must require a covered company to maintain a debt-to-equity ratio of no more than 15-to-1, upon a determination by the Council that (i) such company poses a grave threat to the financial stability of the United States and (ii) the imposition of such a requirement is necessary to mitigate the risk that the company poses to US financial stability. The proposal establishes procedures to notify a covered company that the Council has made a determination under section 165(j) that the company must comply with the 15-to-1 debt-to-equity ratio requirement, defines “debt” and “equity” for purposes of calculating compliance with the ratio, and provides an affected company with a transition period to come into compliance with the ratio.

Early remediation framework

Section 166 of the Dodd-Frank Act directs the FRB to prescribe regulations to provide for the early remediation of financial distress at covered companies so as to minimize the probability that the company will become insolvent and to reduce the potential harm of the insolvency of a covered company to the financial stability of the United States.

The regulation must use measures of the financial condition of a covered company, including regulatory capital ratios, liquidity measures, and other forward-looking indicators as triggers for remediation actions. Remediation requirements must increase in stringency as the financial condition of a covered company deteriorates. Remedies must include, in the initial stages of financial decline of the covered company, limits on capital distributions, acquisitions, and asset growth. Remedies in the later stages of financial decline of the covered company must include a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.

The proposed rule implementing section 166 establishes a regime for the early remediation of financial distress at covered companies that includes several forward-looking triggers designed to identify emerging or potential issues before they develop into larger problems. In addition to regulatory capital triggers, the proposed rule includes triggers based on supervisory stress test results, market indicators and weaknesses in enterprise-wide and liquidity risk management. The proposed rule also describes the regulatory restrictions that a covered company must comply with in each remedial stage.

Transition arrangements and ongoing compliance

In order to reduce the burden on covered companies of coming into initial compliance with the standards, the FRB is proposing to provide phase-in periods. In general, a company that is a covered company on the effective date of the final rule would be subject to the enhanced prudential standards beginning on the first day of the fifth quarter following the effective date of the final rule. A company that becomes a covered company after the effective date of the final rule generally would become subject to the enhanced standards beginning on the first day of the fifth quarter following the date that it became a covered company.

For a variety of reasons, the proposed rule provides different transition arrangements for enhanced risk-based capital and leverage requirements, single-counterparty credit limits and stress testing requirements.

To reduce the burden of ongoing compliance with the enhanced standards, the FRB is also proposing to sequence the timing of required submissions. For example, the requirement that covered companies conduct stress tests is specifically timed to coordinate with the reporting requirements associated with the capital plan, and the capital plan and stress test requirements are specifically timed to minimize overlap with resolution plan update requirements.

Reservation of authority

To address situations where compliance with the requirements of the proposed rule would not sufficiently mitigate the risks to US financial stability posed by the failure or material financial distress of a covered company, the proposed rule includes a reservation of authority provision. This reservation of authority would permit the FRB to implement additional or further enhanced prudential standards for a covered company, including, but not limited to, additional capital or liquidity requirements, corporate governance standards, concentration limits, stress testing requirements, activity limits, or other requirements or restrictions that the FRB may deem necessary to carry out the purposes of the proposal or section 165 of the Dodd-Frank Act.

The proposed rule also specifies that the FRB may determine that a BHC that is not a covered company shall be subject to one or more of the standards established under the proposed rule if the FRB determines that doing so is necessary or appropriate to protect the safety and soundness of the company or to promote financial stability. In addition, the proposed rule would specifically state that nothing in the rule would limit the authority of the FRB under any other provision of law or regulation to take supervisory or enforcement action, including action to address unsafe and unsound practices or conditions, deficient capital or liquidity levels, or violations of law.

Additional information

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