First take

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Five key points from the Fed's new rating system for large financial institutions

On August 3rd, the Federal Reserve (Fed) proposed for comment a new supervisory rating system to assess the safety and soundness of Large Financial Institutions (LFIs).[1] This is the first change to the Fed's supervisory rating system since the financial crisis, and aims to simplify and clarify the existing five-component supervisory assessment process[2] by assigning ratings across three pillars: (1) capital, (2) liquidity, and (3) the effectiveness of governance and controls.

1. **Doubling down on capital and liquidity**. The proposal is designed to focus future ratings on two areas where the Fed has made the most changes to its supervisory process since the financial crisis: the Comprehensive Capital Analysis and Review (CCAR) and the Comprehensive Liquidity Analysis and Review (CLAR) programs. While the existing rating system includes a component of a firm's overall financial condition – with separate sub-ratings for asset quality and earnings in addition to capital and liquidity – the proposal increases the importance of capital and liquidity by making each a pillar in the new three pillar framework. Moreover, the proposal makes explicit that findings from CCAR will account for a material portion of the capital rating, and that findings from coordinated exams of liquidity positions conducted across CLAR will determine the liquidity rating.
2. **All in on governance.** The third pillar of the proposed rating system, the effectiveness of governance and controls, would incorporate all of the risk management assessments and ratings of the current ratings system.[3] This component would be heavily based on the Fed's simultaneously proposed supervisory guidance for boards of directors,[4] and its planned near term release of additional guidance covering a firm's management of core business lines and independent risk management and controls.[5] Both of these guidance documents would be similar in principle to the Office of the Comptroller of the Currency's heightened standards for certain large banks, thrifts, and federal branches, and should provide greater clarity and even relief for firms' boards of directors.

3. **Simpler rating system, same expectations.** Under the proposal, firms will be rated on a four-point scale on each of the three pillars: Satisfactory, Satisfactory Watch, Deficient-1, and Deficient-2. In a notable change from the current system, there will not be any overall or composite rating. Instead, in order to be assessed as "well managed," firms will need to receive a rating of Satisfactory or Satisfactory Watch across all three components. The Satisfactory Watch rating is a new concept that indicates that a firm is not yet Deficient but has a limited time to address an issue in order to be upgraded to Satisfactory or, if not addressed, be downgraded to Deficient.

   Although the proposed system has fewer components, no sub-component ratings, and a narrower ratings scale, it does not indicate any lowering of standards or overall supervisory expectations. Firms rated Deficient 1 in any component would be subject to greater scrutiny and restrictions in order to gain approval to engage in new or expansionary activities, and those rated Deficient 2 in any component would be extremely unlikely to receive approval for such activities and would also be deemed to be in "troubled condition." Receiving either a Deficient 1 or 2 would also likely result in informal or formal enforcement actions.

4. **Reliance on the primary supervisor for depository institutions.** The Fed's proposal removes ratings for both the subsidiary depository institutions (DIs) and for the impact that the parent could have on the DI, thereby marking a reduction in the regulatory burden for most firms. Instead, the Fed would continue to rely on supervisory assessments developed by the primary supervisor of the DI. The proposal, however, makes clear that the new rating system would evaluate a firm's ability to protect the safety and soundness of its DIs, including whether the firm can provide financial and managerial strength to its DIs. Although the proposal gives no detail on how and where this would work under the new three pillar framework, these changes represent a continuation of the Fed's focus on the holding company rather than the DI.

5. **Resolution plans on deck?** Interestingly, the proposal does not include a separate provision for evaluating firms' resolution plans, though recovery plans are scoped in as a part of the governance pillar. The Fed did note that it may revise the rating system in the future to include an additional component for the sufficiency of resolution planning efforts, and even requested comments on whether and how this should be done. However, given the public disclosure of resolution plan assessments, we do not expect the Fed to deem their inclusion in the overall rating framework necessary.

What's next?

The industry will be able to comment on the proposed changes to the ratings system for 60 days, and the Fed proposes to assign initial ratings under the new system beginning in 2018. By aligning the Fed's formal rating system with changes in post-crisis supervisory emphasis, this proposal seems to be in accordance with the Trump Administration's goal for rationalized regulation.[6] Therefore, although this rating system is being proposed before the nominee for Fed Vice Chair of Supervision,[7] Randal Quarles, has been confirmed by the Senate, we do not expect him to object to its finalization.

Endnotes

1. LFIs include domestic bank (and savings and loan) holding companies with more than $50 billion in total assets, and the intermediate holding companies of foreign banking organizations, but excludes insurance companies. All other community and regional bank holding companies would remain subject to the existing system.
2. The current RFI/C (D) rating system includes (R) Risk Management; (F) Financial Condition; potential (I) Impact of the parent company and nondepository subsidiaries on the depository institution(s); (C) Composite rating; and (D) Depository Institution rating. This system has been in place since 2004.
3. The Risk Management rating in the current system has four (separately rated) sub-components: 1. Board and Senior Management Oversight, 2. Policies, Procedures and Limits, 3. Risk Monitoring and Management Information Systems and 4. Internal Controls.
4. See PwC's *First take, Five key points from the Fed's new board expectations guidance* (August 2017).
5. The Fed also plans to separately release additional proposed guidance seeking comment on supervisory expectations relating to a firm's management of core business lines and independent risk management and controls, which is also an element of the Governance and Controls rating.
6. See PwC's *First take, Ten key points from Treasury's first financial regulation report* (June 2017).
7. The Fed Vice Chair of Supervision is a position created by the Dodd-Frank Act and is the Fed Board seat in charge of bank supervision and regulation.

Additional information

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