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FINANCIAL SERVICES FLASH REPORT

Federal Reserve Board Approves Enhanced Prudential Standards

March 17, 2014

On Tuesday, February 18, the Federal Reserve Board (Board) unanimously approved its final Regulation YY rule, which is aimed at strengthening supervision and regulation of large U.S. bank holding companies (BHCs) and foreign banking organizations (FBOs) doing business in the United States.[1] The rule, which was required by Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), was initially proposed by the Board in two parts: December 2011 for BHCs and December 2012 for FBOs. The BHC proposal was the subject of a Protiviti whitepaper entitled "*The Financial Version of Competing in a Marathon? Comments on the Enhanced Prudential Standards Proposal*."[2]

Approval of the Board's final rule follows the January 16, 2014, release of an Office of the Comptroller of the Currency notice of proposed rulemaking, entitled "OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches." This proposed rule is likewise intended to establish enhanced expectations for governance and risk management practices at large national banks and federal savings banks.

For U.S. BHCs with total consolidated assets of $50 billion or more, the final rule incorporates previously issued capital planning and stress testing requirements as enhanced prudential standards. It also requires these companies to:

- Comply with enhanced risk management and liquidity risk-management standards;
- Conduct liquidity stress tests; and
- Hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event.

In addition, the final rule requires publicly traded U.S. BHCs with total consolidated assets of $10 billion or more to establish enterprisewide risk committees. These new requirements complement the stress testing and resolution planning requirements that the Board previously finalized for large bank holding companies.

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[1] See the Federal Reserve Board press release dated February 18, 2014: www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm.

[2] Download *The Financial Version of Competing in a Marathon? Comments on the Enhanced Prudential Standards Proposal* from the Protiviti website: www.protiviti.com/en-US/Documents/White-Papers/Industries/Reg-YY-Enhanced-Prudential-Standards-Protiviti.pdf.

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For FBOs, the final rule did provide some relief from the initial proposal, specifically relating to the requirement to form and capitalize an intermediary bank holding company in the United States. The December 2012 proposal would have required any foreign bank with non-U.S. branch assets of $10 billion or more to form an intermediary holding company; the final rule raises this threshold to $50 billion, providing relief to smaller institutions, but still requiring between 15 and 20 foreign banks to form intermediary holding companies.[3] With other limited exceptions discussed below, the final rule applies the substance of the BHC requirements to FBOs.

Of note, the Board states that its final rule will not apply to nonbank financial companies that are designated by the Financial Stability Oversight Council ("FSOC") for Board supervision. Instead, the Board will apply enhanced prudential standards to these institutions through a subsequently issued order or rule following an evaluation of the business model, capital structure and risk profile of each designated nonbank financial company. In addition, the final rule does not implement single-counterparty credit limits or early remediation requirements for U.S. or foreign banking organizations, which will be implemented at a later date following further study.

The final rule is available here on the Federal Reserve Board website.[4] The effective date of the Final Rule is June 1, 2014, although compliance with most of the new requirements will be phased in between 2015 and 2018.

Regulation YY Requirements

Following is a high-level summary of the final 415-page rule. The summary focuses on the requirements of Regulation YY and does not address the same or similar requirements, e.g., in the case of capital, that may be applied by regulatory bodies other than the Board.

Bank Holding Companies

Risk-Based Capital

The final rule, consistent with the proposal, incorporates existing standards for capital planning stress testing, and risk-based capital and leverage requirements:

- **Capital Planning**: Large bank holding companies (i.e., companies with $50 billion or more in total consolidated assets) are required to submit an annual capital plan to the Board. This plan must address the institution's sources and uses of capital and demonstrate its ability to maintain capital above minimum risk-based capital guidelines under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon.
- **Stress Testing**: Under interagency guidelines adopted in 2012, the Board conducts annual supervisory stress tests of large BHCs and, additionally, requires these companies to perform semi-annual company-run stress tests. BHCs, savings and loan holding companies, and state member banks with more than $10 billion but less than $50 billion in total consolidated assets must perform annual company-run stress tests.

[3] "Fed Eases Up Slightly on Foreign Bank Supervision," Borak, Donna, *American Banker*, February 18, 2014.

[4] The Federal Reserve Board's Regulation YY:
www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf. For a detailed discussion about the implementation dates, refer to the *Implementation Timing for Foreign Banking Organizations* section, pp. 18-22.

- **Risk-Based Capital and Leverage Ratio**: As detailed by the revised capital framework adopted by the Board in July 2013 in response to Basel III and certain changes required by the DFA, the Board introduced a new minimum common equity tier 1 capital ratio of 4.5%. The Board raised the minimum tier 1 ratio from 4% to 6% and required all banking organizations to meet a 4% leverage ratio. BHCs with more than $250 billion in total assets or total consolidated off-balance sheet foreign exposure of at least $10 billion must meet a supplementary leverage ratio of 3%.
- **Additional Capital Buffer**: The final rule indicates that the Board is currently reviewing responses to a July 2013 request for proposal that would require a top-tier U.S. BHC with more than $700 billion in total assets or $10 trillion in assets under custody to maintain a 2% buffer above the 3% supplemental buffer in order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers. The Board further indicates its intent to seek comments on additional enhancements to capital requirements for large BHCs, including a quantitative risk-based capital surcharge based on the Basel Committee's approach.[5]

Risk Management and Risk Committee Requirements

- **Risk Committee Responsibility**: Consistent with the requirements of the DFA, all publicly traded BHCs with total consolidated assets of $10 billion or more must establish risk committees. Acceding to the concerns expressed by commenters to the proposed rule that risk committees were being assigned managerial and operational responsibilities inappropriate for board members, the Board revised the final rule to clarify that the role of the risk committee should be to understand (not "oversee" as proposed) a company's enterprisewide risk management policies and framework and that risk committees should have a general understanding of the risk management practices of the company and "approve and periodically review" the company's enterprisewide risk management policies.
- **Risk Committee Member Qualifications**: Consistent with the proposal, the final rule requires that an independent director must chair the risk committee, but leaves it to the company to determine, based on size, scope and complexity of its operations, how many, if any, additional independent directors serve on the committee. At least one member of the risk committee must have risk management expertise commensurate with the risks of the company. In response to concerns that the definition of "risk management expert" included in the proposed rule was too stringent, the final rule revised the definition as follows:
    - For BHCs with total consolidated assets of more than $10 billion but less than $50 billion, an individual's risk management experience in a non-banking or non-financial field may fulfill the requirement.
    - For BHCs with total consolidated assets of more than $50 billion, the risk management expert must have experience in identifying, assessing and managing risk exposures in large, complex financial firms.
- **Corporate Governance Requirements for Risk Committees**: Risk committees must have a formal written charter that is approved by the company's board of directors. Committees are required to meet at least quarterly and to document fully and maintain records of the committee proceedings.

[5] Basel III: A global regulatory framework for more resilient banks and banking systems. www.bis.org/publ/bcbs189.pdf.

- **Risk Management Framework**: A company's risk management framework must be commensurate with its structure, risk profile, size and complexity and must include:
    - Policies and procedures establishing risk management governance
    - Risk management practices
    - Risk control structure for the company's global operations
    - Processes and systems for implementing and monitoring compliance with risk management policies and procedures

  The final rule did eliminate the proposed requirement that the risk management framework must include specific risk limitations for each line of business in the company.

- **Additional Standards for Large Bank Holding Companies**: For BHCs with total consolidated assets of $50 billion or more, the risk committee must be a stand-alone committee and not part of a joint committee. The risk committee must receive at least quarterly reports from the company's Chief Risk Officer. A Chief Risk Officer is a required position, reporting directly both to the risk committee and to the Chief Executive Officer. The Chief Risk Officer position must be staffed by an individual with experience "identifying, assessing and managing exposures of large, complex financial firms" who has oversight over:
    - The establishment of risk limits and monitoring compliance with those limits
    - Implementation and ongoing compliance with risk management governance; policies, procedures, practices and controls
    - Developing and implementing appropriate processes for identifying and reporting risks
    - Monitoring and testing risk controls
    - Reporting risk management issues and emerging risks
    - Ensuring risk management issues are resolved timely

The final rule recognizes that the Chief Risk Officer may execute some of the above responsibilities by working with, or through, others in the company. Compensation for the Chief Risk Officer must be structured to provide for an objective assessment of the risks taken by the company and, consistent with other Board guidance on compensation for employees in risk and control functions, not be based substantially on financial performance of the business.

Liquidity Requirements

- **Liquidity Risk Management**: The final rule builds on existing Board guidance and is intended to allow flexibility while, at the same time, prescribing some minimum standards which the Board believes should be incorporated in the liquidity risk management practices of all BHCs with total consolidated assets of $50 billion or more.
- **Framework for Managing Liquidity Risk**: The final rule requires the board of directors to approve the company's liquidity risk tolerance at least annually, receive and review information from senior management at least semi-annually to determine whether the company is operating within the established risk tolerances, and to

approve and review periodically liquidity risk management strategies, policies and procedures established by senior management. The final rule shifts responsibility for reviewing and approving the company's contingency funding from the board of directors to the risk committee and also shifts responsibility from the risk committee to senior management for reviewing and approving liquidity costs, benefits and risks for each significant new business line and new product before launch. Senior management is also required (in another change from the proposal that would have required the risk committee to do this) to perform quarterly reviews of the liquidity risk of business lines and products. Senior management is charged as well with the responsibility for establishing liquidity risk limits, reviewing cash flow projections at least quarterly, and approving certain aspects of the liquidity stress-testing framework. When circumstances warrant, senior management is expected to perform more frequent reviews than the frequency established by the final rule.

- **Independent Review of Liquidity Risk Management**: An independent review function must review and evaluate the adequacy and effectiveness of liquidity risk management in BHCs with $50 billion or more in total consolidated assets. To the extent permitted by law, the independent review function must also report material liquidity risk management issues in writing to the board of directors or risk committee for corrective action. The independent review function does not need to be independent of the liquidity risk management function, but must be independent of management functions, such as the treasury function, that execute funding. The Board is in the process of finalizing the substance of the independent review requirements, which are the subject of another proposal.
- **Cash Flow Projections**: The final rule, consistent with the proposal, requires BHCs with total consolidated assets of $50 billion or more to develop cash flow projections over short and long (one year) horizons at least monthly. These cash flow projections must provide sufficient detail to reflect the capital structure, risk profile, complexity, currency exposure, activities and size of the company, including, as warranted, analyses by business line, currency or legal entity.
- **Contingency Funding Plan**: Large BHCs must develop and review at least annually a contingency funding plan (i.e., policies, procedures and action plans) for managing liquidity stress events. This plan is expected to have two components: a quantitative assessment based on identified stress events and an event management process. The event management process must identify the circumstances under which the plan will be implemented, including, but not limited to, the company's failure to meet any minimum liquidity requirement established by the Board. The contingency funding plan must be subject to periodic testing, ranging from liquidation of assets to test the market to "table top" or "war room" exercises.
- **Liquidity Risk Limits**: The final rule, consistent with the proposal, requires each BHC with total consolidated assets of $50 billion or more to establish and maintain limits on potential sources of liquidity, including (1) concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding and other liquidity risk identifiers; (2) the amount of liabilities that mature within various time horizons; and (3) off-balance sheet exposures and other exposures that could create funding needs during periods of stress.
- **Collateral, Legal Entity, and Intraday Liquidity Risk Monitoring**: The final rule preserves the substance of the proposed rule and requires BHCs with $50 billion or more in total assets to establish procedures for monitoring assets it has pledged as

collateral or has available to pledge as collateral within and across significant legal entities, currencies and business lines. It also requires these companies to monitor intraday liquidity risk exposure.

- **Liquidity Stress Testing**: BHCs with total assets of $50 billion or more must perform monthly stress tests as well as ad hoc stress tests to address unexpected circumstances. Stress tests must include a minimum of three stress scenarios (i.e., adverse market conditions, an idiosyncratic stress event, and combined market and idiosyncratic stresses) and a minimum of four periods (i.e., overnight, 30-day, 90-day and one year) over which the stressed projections extend.
- **Liquidity Buffer**: BHCs with total consolidated assets of $50 billion or more must hold highly liquid assets (i.e., a "buffer") sufficient to meet the needs as identified in its internal stress tests to meet expected net cash flows for 30 days for each of the three stress scenarios.

Debt-to-Equity Limits

The final rule adopts the proposed rule and requires that a BHC that poses a "grave threat" to the financial stability of the United States must maintain a debt-to-equity ratio of no more than 15 to 1, whereby "debt" is defined as total liabilities and "equity" is defined as total equity capital. The rule provides 180 days for a BHC to comply with this requirement, with the possibility of two 90-day extensions, once it is notified. The Board has left the clarification of what constitutes a "grave threat" to the FSOC, which is responsible for making the determination.

Foreign Banking Organizations ("FBOs")

- **Intermediary U.S. Holding Companies**: As previously noted, the final rule raised the requirement to establish intermediate U.S. holding companies from the $10 billion or more in owned or controlled non-U.S. branch assets in the proposal to $50 billion or more in non-U.S. branch assets. The final rule does provide an exemption for DPC branch subsidiaries, defined as branches or agencies acquired or formed to hold assets acquired for the purpose of securing or collecting debts previously contracted; these subsidiaries do not have to be transferred to the U.S. intermediate holding company. The final rule also allows the Board to permit alternate or multiple U.S. intermediate holding companies where necessary because of, as an example, home country law or where warranted by the nature and scope of activities. In the case of multiple U.S. intermediate holding companies, each would be treated as a U.S. intermediate holding company with $50 billion or more in total consolidated assets. An FBO may dissolve its U.S. intermediate holding company if its assets fall below the triggering threshold for four consecutive quarters, but would need to re-form the holding company if its assets were subsequently to exceed the threshold for four consecutive quarters.
- **Capital Requirements**: The final rule aligns the capital requirements, including capital planning, for U.S. intermediate holding companies of FBOs with the requirements of domestic BHCs, except that U.S. intermediate holding companies do not have to comply with the advanced approaches rules[6] even where the U.S.

[6] An advanced approaches banking organization is one that meets the asset size or foreign exposure thresholds or has opted to apply the advanced approaches rule, without reference to whether that banking organization has completed the parallel run process and has received notification from its primary Federal supervisor pursuant to section 121(d) of subpart E of the final rule; www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

intermediate holding company is a BHC. Additionally, the implementation of the supplementary leverage ratio was deferred until January 1, 2018.

- **Risk Management Committees**: The final rule requires an FBO with a U.S. presence that has any class of stock (or similar interest) that is publicly traded and total consolidated assets of $10 billion or more, and an FBO with total consolidated assets of $50 billion or more (including combined U.S. assets of $50 billion or more) regardless of whether its stock is publicly traded, to certify to the Board, on an annual basis, that it maintains a U.S. risk committee of its board of directors or equivalent home-country governance structure that (1) oversees the U.S. risk-management policies of the combined U.S. operations of the company, and (2) has at least one member having experience in identifying, assessing, and managing risk exposures of large, complex firms. In deference to home country governance standards, an FBO may locate its risk committee in its U.S. intermediate holding company or may be a committee of the global board of directors of the FBO. However, each U.S. intermediate holding company must have a risk committee; the risk committee of a U.S. intermediate holding company may also serve as the U.S. risk committee.
- **U.S. Chief Risk Officer**: FBOs with combined U.S. operations of $50 billion or more must have a Chief Risk Officer who is employed by a U.S. entity, reports to the U.S. risk committee and is responsible for “overseeing,” rather than being directly responsible for, the execution of risk management activities, including liquidity risk management. Experience expectations for an FBO Chief Risk Officer are consistent with those for a Chief Risk Officer in a domestic BHC.
- **Liquidity Requirements**: The final rule is mostly consistent with the proposal and requires an FBO with combined U.S. assets of $50 billion or more to establish a framework for managing liquidity risk, engage in independent review and cash-flow projections, establish a contingency funding plan and specific limits, engage in monitoring, stress test its combined U.S. operations and its U.S. intermediate holding policies for managing liquidity risk established by senior managers, and regularly report to the U.S. risk committee. The U.S. risk committee or designated subcommittee must review the contingency funding plan of the FBO. The U.S. Chief Risk Officer is required to approve each new business line and new product and ensure that the liquidity costs, benefits and risks of each new business line and each new product offered, managed or sold through the company’s combined U.S. operations that could have a significant effect on the company’s liquidity risk profile are consistent with the company’s liquidity risk tolerance, and to review at least annually significant business lines and products offered, managed or sold through the combined U.S. operations to determine whether such business or product has anticipated liquidity risk and to confirm that the strategy or product is within the established liquidity risk tolerance.

  The final rule is differentiated from the proposal in the requirements for liquidity buffers. The final rule retains the requirement that separate liquidity buffers must be held for U.S. branches/agencies and U.S. intermediate holding companies however, the final rule only requires U.S. branches/agencies to maintain a liquidity buffer for days 1-14 of a 30-day stress scenario. Liquidity buffer assets must be reflected on the balance sheets of U.S. branches/agencies and the U.S. intermediate holding company, i.e., they cannot be held outside of the United States.

- **Stress Test Requirements**
    - **U.S. Intermediate Holding Company**: The final rule requires an intermediate U.S. holding company with combined U.S. assets of $50 billion or more to perform annual supervisory and semi-annual company-run stress tests. For the annual stress tests, all institutions would be required to file regulatory reports with the Board by January 5 and publicly disclose a summary of the results under the severely adverse scenario between March 15 and March 31 of each year. For the mid-cycle tests, all institutions would be required to file the regulatory reports with the Board by July 5 of each year and disclose a summary of results between September 15 and September 30.
    - **Branches and Agencies of FBOs**: A branch or agency of an FBO with combined U.S. assets of $50 billion or more is required to perform annual supervisory stress tests. These stress tests can be conducted in accordance with their home-country supervisor provided they meet the requirements of the final rule. Additionally, they will be required to show they have adequate controls and governance over the stress testing process and are able to provide management and the Board with useful and timely information.
    - **Information Requirements for all FBOs**: The final rule requires an FBO with $50 billion or greater in combined U.S. assets to submit the following information regarding the results of their home country stress tests:
    - Description of the types of risks included in the stress test
    - Description of the conditions or scenarios used in the stress test
    - Summary description of the methodologies used in the stress test
    - Estimates of the foreign banking organization's projected financial and capital condition
    - Explanation of the most significant causes for any changes in regulatory capital ratios

    However, if the FBO is subject to different home country metrics, the Board would expect to accept those metrics, provided they include sufficient information on the FBO's losses, revenues, changes in expected loan losses, income and capital under stressed conditions.

    - **Stress-test Requirements for FBOs with Total Consolidated Assets of More than $50 Billion but Combined U.S. Assets of Less than $50 Billion**: The final rule requires these FBOs to satisfy the same requirements as FBOs with combined U.S. assets greater than $50 billion. These requirements include the home-country stress testing regime with either an annual supervisory capital stress test or an annual supervisory evaluation and review of a company-run stress test. Additionally FBOs must maintain requirements for governance and controls over the stress-testing practices. If the FBO did not meet its home country requirements, the FBO's U.S. branches and agencies would be required to maintain eligible assets of 105 percent of third-party liabilities calculated on an aggregate basis and conduct and report findings to their board regarding the annual stress test of its U.S. subsidiaries.

  - **Stress Testing Requirements for other FBOs**: The final rule requires FBOs and foreign savings and loan holding companies with total consolidated assets of more than $10 billion but less than $50 billion to meet stress testing requirements, but would allow these institutions to utilize home country stress tests to limit the regulatory burden.

- **Information Requirements for Branches and Agencies of FBOs in a Net Due Position**: The final rule requires branches and agencies in a net due position (i.e., a branch or agency which on a net basis owes funds to its parent/affiliates) to provide additional information regarding their stress tests, including but not limited to a more detailed description of the methodologies used in the stress test, detailed information regarding the FBO's projected financial and capital position over the planning horizon, and any additional information deemed necessary in order to evaluate the ability of the FBO to absorb losses in stressed conditions by January 5 of each calendar year. The actual information required will be determined by the Board on a case-by-case basis, based on the size, complexity, and business activities of the FBO and its U.S. operations.
- **Supplemental Information for Non-Compliant FBOs**: The final rule requires an FBO with $50 billion or more in U.S. assets, which does not comply with stress testing requirements to meet an asset-maintenance requirement by maintaining eligible assets equal to 108 percent of third-party liabilities in addition to conducting annual stress tests of any U.S. subsidiary not held under a U.S. holding company. The rule allows for the Board to notify the non-compliant FBO within the set time periods. The Board is then able to impose intragroup funding restrictions or increased liquidity requirements on the FBO's U.S. branches and agencies and U.S. subsidiaries not part of a U.S. intermediate holding company.
- **Debt-to-Equity Ratio for FBOs**: The final rule requires FBOs to maintain the same 15-to-1 debt-to-equity ratio as U.S. entities as described earlier and determined by the FSOC. The requirement would be applied to FBOs, their U.S. intermediate holding company and/or any U.S. subsidiary not organized under a U.S. intermediate holding company. Additionally, they would need to maintain a 108 percent asset-maintenance requirement on the FBO's U.S. branches and agencies as a proxy for debt-to-equity ratio limitation. The FBO would receive notification from the FSOC or the Board on behalf of the FSOC, and the FBO would have 180 calendar days from the notification to be compliant, with the potential for up to two 90-day extensions based on formal written presentation of relevant facts and the institution's circumstances, which would be reviewed and approved by the Board. The FBO would no longer be subject to the debt-to-equity rule once it received written confirmation from the FSOC that it is no longer a "grave threat."

Closing Thoughts

In a press release accompanying the final rule, Federal Reserve Board Chairman Yellen made the following comments:

> *As the financial crisis demonstrated, the sudden failure or near failure of large financial institutions can have destabilizing effects on the financial system and harm the broader economy. And, as the crisis also highlighted, the traditional framework for supervising and regulating major financial institutions and assessing risks contained material weaknesses. The final rule would help address these sources of vulnerability.*
>
> *In developing the requirements for both domestic and foreign banking organizations, the Board has sought to strengthen U.S. financial stability and reinforce its longstanding policy of national treatment and equality of competitive opportunity between the U.S. operations of foreign banking organizations and U.S. banking firms.*

Some argue that the Board's efforts to strengthen the resilience of individual institutions will only serve to weaken the overall financial system and will, thus, negatively affect economic growth.[7] Only time will tell if this ominous prediction is true. In the interim, BHCs and FBOs will need to make significant operational changes, rewrite policies and procedures, train personnel, and adjust and expand audit coverage to address the new requirements.

The above analysis is not intended to provide legal analysis or advice, nor does it purport to address all of the details and complexities of Regulation YY. BHCs and FBOs should seek the advice of legal counsel or other appropriate advisers on specific questions as they relate to their unique circumstances.

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[7] "Liquidity Rules Fortify the Banks, Weaken the Financial System," American Banker BankThink, Ireland, Oliver, February 5, 2014.

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