Proposed Enhanced Prudential Requirements for US-Based Systemically Important Financial Institutions

On December 20, 2011, the Federal Reserve proposed regulations to implement the enhanced prudential standards mandated by Section 165 and the early remediation requirements mandated by Section 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") with respect to US-based systemically important financial institutions.

The proposed regulations are designed to reduce the risks inherent in the operations of large banking organizations and systemically important nonbank financial companies principally through improvements in the organization's quantity and quality of capital, liquidity management, limits on credit exposure concentrations, and limits on the ability of these institutions to leverage their capital base. To that effect, the proposed regulations mandate extensive stress testing requirements, cash flow projections and analysis, capital planning, and improvements to risk management structures and processes. The proposed regulations also provide a set of tools that expand the existing supervisory powers of the Federal Reserve to intervene early upon identification of financial weaknesses or finding of deteriorating management or financial condition of a covered financial institution that may affect its ability to withstand adverse economic and financial market conditions. In addition to requiring more capital and constraining capital leverage and corresponding returns on capital, the proposed regulations would impose significant incremental compliance costs and regulatory risk. The proposed regulations are also indicative of the much more intrusive and hands on approach that US regulators are adopting towards large banking organizations and nonbank financial institutions deemed to be systemically significant. In this memorandum we provide an overview of the provisions of the proposed regulations and encourage covered companies to actively participate in the rulemaking consultative process. Comments on the proposal are due by March 31, 2012.

Covered Companies

Under the statutory provisions of the Dodd-Frank Act, covered companies for purposes of the enhanced prudential and early remediation requirements are: (i) bank holding companies ("BHCs") with total consolidated assets of $50 billion or more as determined based on the average total assets reported on the company's four most recent quarterly financial regulatory reports; and (ii) nonbank financial companies designated systemically important by the Financial Stability Oversight Council ("FSOC"). Under the proposed regulations, "covered companies" would comprise

Key issues

- Capital Requirements
- Liquidity Requirements
- Single-Counterparty Credit Exposure Limits
- Risk Management Requirements
- Stress Testing Requirements
- Debt-to-Equity Limit
- Early Remediation Framework

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only US-based BHCs and US-based nonbank financial companies that are covered companies under the statute.

By the terms of the statute, the enhanced prudential and early remediation requirements apply to any nonbank financial company designated systemically important by the FSOC and to both US-based and non-US banking organizations with more than $50 billion in total worldwide consolidated assets that are BHCs by virtue of controlling a US bank subsidiary, or are treated as BHCs by virtue of operating a US branch, agency, or commercial lending company ("foreign banking organizations"). The proposed regulations would not apply to foreign banking organizations, however, except that a US-based BHC subsidiary of a foreign banking organization that on its own has total consolidated assets of $50 billion or more would be a "covered company" for purposes of the proposed regulations. In other words, the proposed regulations would not apply to operations of foreign banking organizations conducted in or outside the United States, other than any operations conducted within the ownership chain of any US-based BHC with total consolidated assets of $50 billion or more. The Federal Reserve stated that, in light of differing approaches to prudential regulation across jurisdictions, existing international agreements concerning prudential standards, home-host supervisory issues, and the diverse structure of US operations of foreign banking organizations, the application of the enhanced prudential and early remediation requirements to foreign banking organizations would be difficult. Nonetheless, the Federal Reserve has stated that it is actively developing a proposal for applying the enhanced prudential and early remediation requirements to foreign banking organizations and expects to issue this proposal shortly.

Effective Date

Generally, covered companies would become subject to the enhanced prudential requirements beginning on the first day of the fifth quarter following the effective day of the final regulations. A company that becomes a covered company after the effective day of the final regulations would become subject to the enhanced prudential requirements beginning on the first day of the fifth quarter following the date the company became a covered company. As discussed below, different transition arrangements are provided for enhanced risk-based capital and leverage requirements, credit exposure limits, and stress testing requirements.

Statutory Enhanced Prudential Requirements Implemented by the Proposed Regulations

The enhanced prudential standards required under Section 165 of the Dodd-Frank Act must include: (i) risk-based capital and leverage requirements; (ii) liquidity requirements; (iii) overall risk management requirements; (iv) resolution plan and credit exposure reporting requirements; (v) single-counterparty credit concentration limits; and (vi) a debt-to-equity limit upon a determination of a grave threat to the financial stability of the United States. Section 165 also mandates stress testing for BHCs and state member banks with more than $10 billion in total consolidated assets. It further mandates the establishment of risk committees for publicly traded BHCs with total consolidated assets of $10 billion or more. As discussed more fully below, the proposed regulations address all of these requirements, other than the resolution plan and credit exposure reporting requirements. A rule implementing the resolution plan requirement of the Dodd-Frank Act was issued in final on November 30, 2011, jointly by the Federal Reserve and the Federal Deposit Insurance Corporation. A rule implementing the credit exposure reporting requirements is expected at a later date.

In addition to the mandatory enhanced prudential standards, under Section 165 the Federal Reserve may also impose: (i) contingent capital requirements; (ii) enhanced public disclosures; (iii) short-term debt limits; and (iv) such other prudential standards that the Federal Reserve determines are appropriate. The Federal Reserve has not proposed such requirements at this time.

Authority to Modify or Impose More Stringent Requirements

The proposed regulations would apply the same set of enhanced prudential standards to all covered companies. The Federal Reserve has authority, however, to tailor the enhanced prudential standards on an institution-by-institution basis or by category, taking into account any given institution's capital structure, riskiness, complexity, financial activities, size, and any other risk-related factor that the Federal Reserve deems appropriate. The ability of the Federal Reserve to differentiate among companies in applying the enhanced prudential standards should be particularly relevant and important concerning the application of these standards to designated nonbank financial companies and to foreign banking organizations.

The proposed rules also contain reservation of authority provisions that would permit the Federal Reserve to implement additional or further enhanced prudential requirements for a covered company that the Federal Reserve may deem necessary to carry out the purposes of Section 165 of the Dodd-Frank Act. Furthermore, under the proposed regulations the Federal Reserve may determine that a BHC that is not a covered company shall be subject to one or more of the enhanced prudential standards if the Federal Reserve determines that doing so is necessary or appropriate to protect the safety and soundness of the company or to promote financial stability.

Capital Requirements

The proposed regulations indicate that the Federal Reserve intends to implement enhanced capital requirements for covered companies in two stages. The proposed regulations are only the first stage of this process. In the commentary to the proposed regulation the Federal Reserve states that it intends to supplement the enhanced capital requirements of the proposed regulations by implementing a quantitative risk-based surcharge for "covered companies or a subset of covered companies" based on the Basel III capital framework. The Federal Reserve expects to adopt rules implementing the risk-based capital surcharge during 2014 with a phase-in compliance period from 2016-2019. It appears that the Federal Reserve is still undecided as to the scope of application of the Basel III framework in the United States. Given that the Basel III framework by its terms applies only to the largest internationally active bank, however, it is likely that the risk-based capital surcharge of the Basel III framework would apply only to a subset of covered companies.

As a first stage of the implementation of enhanced capital requirements, the proposed regulations would require compliance with any regulation relating to capital plans and stress tests. The proposed regulations would also require nonbank covered companies to comply with the minimum risk-based capital requirements applicable to covered companies that are BHCs.[1] The Federal Reserve published a capital plan regulation on December 1, 2011, which generally would require covered companies to submit a board-approved annual capital plan to the Federal Reserve. The capital plan must demonstrate the ability of the covered company to maintain the minimum regulatory risk-based capital ratios and a tier 1 common risk based capital ratio of 5 percent over a nine-quarter planning horizon under both expected and stressed conditions. The capital plan must provide detailed description of all planned capital actions during the period and how the institution will maintain adequate capital under stressful conditions. Covered companies will be unable to make capital contributions until the Federal Reserve has approved their capital plan.

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[1] Currently, the minimum required regulatory capital ratios are: (i) total risk-based capital ratio equal to 8 percent; (ii) tier 1 risk-based capital ratio equal to 4 percent; and (iii) leverage ratio equal to 4 percent.

Liquidity Requirements

As is the case with the enhanced regulatory capital requirements, the Federal Reserve intends to impose enhanced liquidity requirements in stages. The proposed regulations are the first stage of this process. The second stage would entail additional regulations that would require covered companies or a subset of covered companies to satisfy specific quantitative liquidity requirements consistent with the Basel III liquidity standards. The Basel III liquidity framework would require covered companies to maintain: (i) a liquidity coverage ratio ("LCR") to ensure that the company has sufficient liquid assets to offset net cash outflows that could be experienced under a short term financial stress lasting up to 30 days; and (ii) a net stable funding ratio ("NSFR") designed to prevent funding of long term assets with overnight liabilities expressed as a minimum amount of stable funding sources relative to the liquidity profile of the assets portfolio of the institution.[2] Basel III would require the LCR and NSFR to be implemented by the member countries of the Basel Committee by 2015 and 2018, respectively. The Federal Reserve has indicated that it is currently considering a joint proposal with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation to implement the Basel III liquidity framework in the United States.

The enhanced liquidity framework established by the proposed regulations would build upon existing supervisory guidance and would impose specific regulatory liquidity requirements including: (i) cash flow projections; (ii) liquidity stress testing; (iii) liquidity buffer; (iv) contingency funding plan; (v) specific limits on sources of liquidity risk; and (vi) corporate governance, monitoring, and documentation requirements. These requirements are discussed in further detail below.

Cash Flow Projections

Covered companies would be required to produce comprehensive cash flow projections over short-term and long-term horizons that are commensurate in analysis, methodology, and detail to the covered company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. The cash flow projections would have to be based on reasonable assumptions regarding the future behavior of assets, liabilities, and off-balance sheet items, and would have to include cash flow projections arising from contractual maturities, new business, funding renewals, customer options, and other events that could potentially impact liquidity.

Liquidity Stress Testing

The proposed regulations would require stress testing of the cash flow projections using a range of stress test scenarios. At a minimum, the stress test scenarios would have to include market stress, idiosyncratic stress, and combined idiosyncratic and market stress. The stress tests would have to be tailored to, and provide sufficient detail to reflect, a covered company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. Covered companies would use the results of the stress tests to analyze their liquidity risk exposure, the impact of adverse events and market conditions on liquidity, and to set the size of the required liquidity buffer. In addition, results of the stress tests would be used for purposes of the quantitative assessment of liquidity needs for purposes of the required contingency funding plan.

Covered companies would be required to conduct liquidity stress testing at least monthly using a minimum of four time horizons: (i) overnight; (ii) 30-day; (iii) 90-day; and (iv) one-year. Because the results of the stress testing would determine the required liquidity buffer, the proposed regulations mandate that the covered company assumes that only highly liquid and unencumbered

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[2] Stable funding resources include capital, liabilities with maturities of more than a year, certain deposits and other liabilities with less than a year that are expected to stay in the institution for an extended period of time even during a stress period. All of these funding resources are assigned a factor, which in effect is a haircut for less stable funding sources.

assets may be used as cash flow sources to meet projected funding needs during the first 30 days in any stress test scenario. The proposed regulations also would require that all assets used to cover projected funding needs are adjusted to fair market value and are sufficiently diversified throughout each stress test time horizon.

Liquidity Buffer

Covered companies would be required to maintain a liquidity buffer of unencumbered highly liquid assets sufficient to meet projected net cash outflows and the projected loss of impairment of existing funding sources for 30 days for a range of liquidity stress scenarios. The Federal Reserve has stated that the capital buffer is consistent with the effort toward developing a comprehensive liquidity framework that would eventually incorporate the LCR. As noted above, the Basel III LCR would require a covered company to maintain "an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors." In effect, there appears to be little difference between the minimum amount of liquidity funding required under the LCR and the liquidity buffer imposed under the proposed regulations. Even though the liquidity buffer should be based on a "range of liquidity stress scenarios," the amount of the assets included in the liquidity buffer should reflect the most severe stress scenario, which is consistent with the significantly severe liquidity stress test scenario used to calculate the LCR. Notably, however, the proposed regulations are somewhat unclear as to whether the liquidity buffer may be reduced during periods of stress, stating that the buffer must be maintained "continuously." The Basel Committee, on the other hand, has stated that once the LCR has been implemented, its 100 percent threshold will be a minimum requirement in normal times but, during a period of stress, banks would be expected to use their pool of liquid assets, thereby temporarily falling below the minimum requirement.

As is the case with the LCR, the type of assets that may be included in the liquidity buffer are limited to highly liquid unencumbered assets. The assets comprising the liquidity buffer must be discounted to fair market value and must be diversified throughout each stress test time horizon by instrument type, counterparties, geographic market, etc. In addition, the proposed regulations specify that the size of the liquidity buffer must be aligned to the covered company's capital structure, risk profile, complexity, activities, size, and any other risk-related factors that are appropriate.

Contingency Funding Plan

Covered companies would be required to establish and maintain a contingency funding plan ("CFP") for responding to a liquidity crisis. The CFP would have to be commensurate with the covered company's capital structure, risk profile, complexity, activities, size, and any other risk-related factors that are appropriate, and established liquidity risk tolerance. The CFP would include: (i) quantitative assessment; (ii) an event management process; (iii) monitoring procedure for emerging liquidity stress events; and (iv) testing requirements to assess the reliability of the CFP and the availability of alternative liquidity funding.

The quantitative assessment of liquidity needs and funding sources would be based on liquidity stress testing and would entail: (i) identification of stress events that may have significant impact on the covered company's liquidity (e.g., ratings downgrade, asset quality deterioration, operating losses); (ii) assessment of the level an nature of the impact of a stress event; (iii) assessment of available funding sources and needs during a stress event; and (iv) identification of alternative liquidity sources that may be access during a stress event. The commentary to the proposed regulations notes that Federal Reserve discount window credit may be incorporated in the CFP as a potential source of liquidity, provided that the terms of discount window borrowing could be met. The event management process requirements would include: (i) an action plan describing the strategies for responding to an identified liquidity stress events; (ii) an event management team; (iii) specification of the process, responsibilities, and triggers for invoking the CFP; and (iv) mechanism that ensures effective communication within the company and with supervisors and counterparties.

Specific Limits

The proposed regulations would require a covered company to establish specific limits on potential sources of liquidity risk reflecting the covered company's capital structure, risk profile, complexity, activities, size, any other risk-related factors that are

appropriate, and established liquidity risk tolerance. In particular, covered companies would have to diversify their liquidity funding by establishing limits on funding by: (i) a single counterparty; (ii) counterparty type; (iii) instrument types; (iv) instrument maturities; and (v) other appropriate risk identifiers. In addition, covered companies would have to establish a limit on off-balance sheet or other contractual or non-contractual exposures that could create funding needs during liquidity stress events.

Monitoring

The proposed regulations would required covered companies to monitor: (i) assets pledged as collateral and available to be pledged in relation to contractually required security; (ii) liquidity risk across legal entities, currencies, and business lines; (iii) intraday liquidity risk exposure; and (iv) compliance with the specific limits on potential sources of liquidity risk noted above.

Corporate Governance and Documentation

The proposed regulations would vest ultimate responsibility for liquidity risk management with the covered company's board of directors. The board of the covered company would be required to: (i) establish the company's liquidity risk tolerance at least annually; (ii) approve from a liquidity risk perspective each new business line and significant new product; (iii) approve the company's CFP at least annually; (iv) review and approve at least quarterly the company's 90-day and one year cash flow projections, stress test results, size and composition of the liquidity buffer, specific limits on sources of liquidity risk, and liquidity risk management information necessary to identify, measure, monitor and control liquidity risk.

The senior management of covered companies would be required to develop and implement the covered company's liquidity risk management strategies, policies, and procedures, and would be required to regularly (but no less frequently than quarterly) submit management reports to the risk committee or a designated subcommittee of the board of directors to facilitate its oversight of the liquidity risk management process and the liquidity risk profile of the company. Covered companies would also be required to establish and maintain an independent review function that would, at least annually, evaluate the adequacy and effectiveness of the covered company's liquidity risk management and assess compliance with applicable laws, regulations, and supervisory guidance. The review function would report to the board of directors and must be independent of management functions that execute funding.

The proposed regulations would require covered companies to document all material aspects of its liquidity management process and its compliance with the proposed regulations and to submit such documentation to the risk committee.

Single-Counterparty Credit Exposure Limits

Section 165(e) of the Dodd-Frank Act directs the Federal Reserve to implement regulations that limit the maximum credit exposure of covered companies to a single unaffiliated counterparty to 25 percent of the capital stock and surplus of the covered company and authorize the Federal Reserve to impose a lower limit if necessary to mitigate systemic risks. Consistent with the statute, the proposed regulations would provide that no covered company shall, together with its subsidiaries, have an aggregate exposure to an unaffiliated counterparty that exceeds 25 percent of the consolidated capital stock and surplus of the covered company. In addition to the statutorily mandated 25 percent limit, the proposed regulations would impose an aggregate net credit limit of 10 percent on the aggregate net credit exposure of a "major covered company" to a "major counterparty." A "major covered company" would be any covered company with total consolidated assets of $500 billion or more. A "major counterparty" would be defined as a "major covered company" or a foreign banking organization that has total consolidated assets of $500 billion or more. "Capital stock and surplus" of a covered company would be the company's total regulatory capital plus excess loan loss reserves. The net credit exposure limits would not apply to any covered company until October 1, 2013. Intraday

credit exposures and exposures to the US federal government are exempt from the credit exposure limit.

The net credit exposure limit would apply on a consolidated basis, which would require covered companies to aggregate the exposures of each of their subsidiaries to a single counterparty.[3] As in the BHCA, the term subsidiary is defined as any company that the covered company directly or indirectly "controls." In contrast to the definition of "control" under the BHCA, however, the Federal Reserve has proposed to adopt a three-pronged bright line control test, which it deemed to be more consistent with the objectives of the single-counterparty credit limits. For purposes of the proposed regulations, a company will be deemed to be controlled by another company and, therefore a subsidiary of the first company, if the first company: (i) owns or controls with the power to vote 25 percent or more of the a class of voting securities of the second company; (ii) owns or controls 25 percent or more of the total equity of the second company; or (iii) consolidates the second company for financial reporting purposes.

The proposed regulations indicate that a fund advised by a covered company would not be deemed to be a subsidiary solely by virtue of the advisory relationship. If a fund is not otherwise controlled by a covered company the exposures of the fund to its counterparties would not be aggregated with those of the covered company. The Federal Reserve has asked, however, whether advised funds should be deemed to be part of the covered company for purposes of the single-counterparty exposure limit, even where the fund is not "controlled" by the covered company, since covered companies tend to support funds they sponsor and advise in times of stress.

In a rare departure of the more expansive reading of its authority, the Federal Reserve has indicated that it would narrowly construe the statutory attribution rule, which requires a covered company to treat any of its transactions with any person as a credit exposure to a counterparty to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty. The Federal Reserve sensibly noted that overly broad interpretation of the attribution rule would create a daunting tracking exercise for covered companies and indicated that it would limit the scope of the attribution rule to preventing evasion of the single-counterparty credit limit.

Under the proposed regulations, a "counterparty" would be: (i) a natural person and the members of the person's immediate family, collectively; (ii) a company and all of its subsidiaries, collectively; (iii) the US federal government and all of its agencies and instrumentalities, collectively (but direct claims on and portions of claims that are directly and fully guaranteed as to principal and interest by the US federal government and its agencies are exempt from the credit exposure limit); (iv) each state government and all of its agencies, instrumentalities, and political subdivisions; and (v) a foreign sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively. This definition would require covered entities to understand the organizational structure of their counterparties to be able to track exposure on an aggregate basis. As a practical matter, obtaining structural information regarding all of the subsidiaries or instrumentalities of every counterparty prior to entering into a transaction that creates a credit exposure to such counterparty is not going to be easy, to say the least. Additional complications in determining which entities comprise the covered company's counterparty may arise in the context of exposures to a special purpose vehicle ("SPV"). The Federal Reserve has asked for comment about the proper assessment of exposure concentration in the context of SPV exposures, and has stated that it may use its reservation of authority to look through collateralized debt obligations or other obligations issued by an SPV to the SPV's sponsor or the issuer of the underlying assets in the vehicle to properly assess a covered company's exposure to those parties.

The proposed regulations define the transactions that create a credit exposure to a counterparty broadly as any: (i) extension of credit, including loans, deposits, and lines of credit, but excluding advised or other uncommitted lines of credit; (ii) repurchase or

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[3] The limit would be in addition to investment securities limits and lending limits to which individual bank subsidiaries of covered companies are already subject.

reverse repurchase agreement; (iii) securities lending or securities borrowing transaction; (iv) guarantee, acceptance, or letter of credit issued on behalf of the counterparty; (v) purchase of, or investment in, securities issued by the counterparty; (vi) credit exposure to the counterparty in connection with a derivative transaction between the covered company and the counterparty; (vii) credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction between the covered company and a third party, the reference asset of which is an obligation or equity security issued by the counterparty; (viii) any transaction that is the functional equivalent of the above; and (ix) any similar transaction that the Federal Reserve determines to be a credit transaction.

The proposed regulations describe how gross credit exposures must be calculated for each type of credit transaction and specify how to convert gross exposure amounts into net credit exposures by taking into account the effect of bilateral netting arrangements, eligible collateral, eligible guarantees, eligible credit and equity derivatives, and other eligible hedges. The Federal Reserve did not proposed a gross credit exposure stating that gross limits tend to significantly overstate the credit risk inherent in any given transaction, but also stated that gross exposure credit limits might more effectively capture interconnectedness among covered companies and asked for comments on whether the net credit exposure limit should be supplemented with a gross credit exposure limit.

Risk Management Requirements

The proposed regulations would require every covered company and every publicly traded BHC with total consolidated assets of $10 billion or more to establish a risk committee of the board of directors, which must be chaired by an independent director. The risk committee would have to have a formal charter approved by the board of directors and would have to fully document and maintain records of its meetings and decisions. The risk committee would have to have at least one member with risk management expertise that is commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. The Federal Reserve has also stated that it would expect that other risk committee members should also have risk management expertise commensurate with the risk profile of the company and should also have experience in developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls.

The risk committee of a covered company would be subject to three additional structural requirements that are not applicable to a publicly-traded over $10 billion BHC that is not a covered company. In the case of a covered company, the risk committee would also have to: (i) be stand-alone (i.e., not housed within another committee or a joint committee); (ii) report directly to the board of directors; and (iii) receive and review regular reports from the company's chief risk officer.

The risk committee would be tasked with establishing an enterprise-wide risk management framework commensurate with the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors that include: (i) risk limitations appropriate to each business line of the company; (ii) appropriate policies and procedures relating to risk management governance, risk management practices, and risk control infrastructure for the enterprise as a whole; (iii) processes and systems for identifying and reporting risks and risk management deficiencies, including emerging risks, on an enterprise-wide basis; (iv) monitoring of compliance with the company’s risk limit structure and policies and procedures relating to risk management governance, practices, and risk controls across the enterprise; (v) effective and timely implementation of corrective actions to address risk management deficiencies; (vi) specification of management and employees’ authority and independence to carry out risk management responsibilities; and (vii) integration of risk management and control objectives in management goals and the company’s compensation structure.

Covered companies would also be required to appoint a chief risk officer ("CRO") to be in charge of implementing and maintaining the risk management framework approved by the risk committee. This requirement does not apply to a publicly-traded over $10 billion BHC that is not a covered company. The CRO would report directly to the risk committee and the chief executive officer. Covered companies would have to ensure that the CRO has appropriate expertise and stature and is compensated in a manner that promotes an objective assessment of the risks taken by the covered company.

Stress Testing Requirements

The Federal Reserve commenced stress testing of large, complex banking organizations in 2009 as part of its efforts to stem the financial crisis. The Federal Reserve views stress testing as a tool that helps ensure that financial companies would have sufficient capital during periods of stress. Section 165(i) of the Dodd-Frank Act has now made annual stress testing of covered companies by the Federal Reserve mandatory ("supervisory stress tests"). In addition, Section 165(i) requires BHCs (that are not covered companies) and state member banks with more than $10 billion in total consolidated assets ("over $10 billion companies"), as well as covered companies, to conduct stress tests and to report the result of such stress tests to the Federal Reserve ("company-run stress tests"). The supervisory and company-run stress testing requirements that would be implemented by the proposed regulations are discussed in turn below.

Supervisory Stress Tests

Supervisory stress tests of covered companies would be conducted annually by the Federal Reserve. Companies that are covered companies on the effective date of the proposed regulations would have to comply with the supervisory stress test requirements as of the effective date of the proposed regulations.

The Federal Reserve is statutorily required to conduct stress tests using at least three different scenarios: (i) baseline; (ii) adverse; and (iii) severely adverse conditions. The Federal Reserve plans to publish the scenarios in advance of conducting the annual stress tests. The proposed regulations indicate that the Federal Reserve envisions that the scenarios would be based on the projected paths of a series of economic and financial variables over the stress test planning horizon, including projections for a range of macroeconomic and financial indicators, such as real GDP, the unemployment rate, equity and property prices, and other financial variables. The Federal Reserve may supplement the scenarios with market price and rate "shocks" that are in line with historical market events or specified by the Federal Reserve. The proposed regulations indicate that the baseline scenario would generally be based on views of the macroeconomic outlook expressed by government agencies, other public-sector organizations, and private-sector analysts as of the beginning of the annual stress-test cycle. The adverse economic scenario may include economic and financial conditions consistent with a recession of moderate intensity. The severely adverse scenario would represent economic and financial conditions that are more unfavorable than those of the adverse scenario and could include drastic declines in asset prices, shifts in the shape of the yield curve, among other variables.

For purposes of the supervisory stress tests, covered companies would be required to submit to the Federal Reserve data schedules that would supplement information collected through the regulatory reporting process in a manner and form prescribed by the Federal Reserve. Such data generally would have to be submitted no later than 40 days after the end of each calendar quarter, although some items may need to be collected on a monthly or only on an annual basis. The Federal Reserve has stated that it plans to issue a separate information collection proposal to support its annual supervisory stress test analyses.

The Federal Reserve would use a series of models and estimation techniques to project losses, revenues, and how a covered company's balance sheet would change over time. Information about planned acquisitions and divestitures and assumptions about corporate actions that may affect capital, such as provisioning, dividends, and share repurchases would be incorporated in the stress testing models. The calculated projections would be analyzed to assess the impact on the capital position of covered companies at the end of each quarter of the planning horizon.

The Federal Reserve intends to communicate to each covered company the results of its analyses within a reasonable period of time after completion of the stress tests. Covered companies would be required to take the results of the supervisory stress tests into account in making any appropriate changes to the company's capital structure, its exposures, concentrations, risk positions, and in updating its capital plan. In addition, covered companies would have to update their resolution plans as the Federal Reserve determines appropriate on the basis of the supervisory stress tests. The stress testing may also trigger the early remediation framework described below.

The proposed regulations indicate that the Federal Reserve will publish high-level summary company-specific stress test results within a reasonable period of time after completing the tests but no later than mid-April of each calendar year. The published results for each covered company are expected to include estimated: (i) losses; (ii) pre-provision net revenue; (iii) allowance for loan losses; and (iv) pro forma regulatory and other capital ratios. The commentary to the proposed regulations states that the Federal Reserve recognizes that there are important considerations related to such public disclosure and requests comments on its proposal to publish company-specific stress test results.

Company-run Stress Tests

Under the proposed regulations covered companies would be required to conduct semi-annual company-run stress tests and over $10 billion companies would be required to conduct annual company-run stress tests. A company that is a covered company or an over $10 billion company on the effective date of the proposed regulations would have to comply with the company-run stress test requirements as of the effective date of the proposed regulations.

The Federal Reserve would provide annually at least three stress test scenarios, including a baseline, adverse, and severely adverse scenario to covered companies and over $10 billion companies, which these companies would be required to use for the annual company-run stress tests. These scenarios are expected to be the same as the scenarios the Federal Reserve would use for the supervisory stress tests. For the semi-annual stress tests that covered companies must conduct, each covered company would be required to develop and employ scenarios reflecting a minimum of three sets of economic and financial conditions, including baseline, adverse, and severely adverse scenarios, and such additional conditions as the Federal Reserve determines appropriate.

Covered companies and over $10 billion companies would have to use the applicable scenarios to calculate potential losses, pre-provision revenues, allowance for loan losses, pro-forma capital positions, and the potential impact on their capital levels and ratios for each quarter-end over the planning horizon. The results of the company-run stress tests, including related qualitative and quantitative information, would have to be reported to the Federal Reserve in a manner and form prescribed by the Federal Reserve.

Under the proposed regulations each covered company and over $10 billion company would be required to establish and maintain a system of controls, oversight, and documentation, including policies and procedures, designed to ensure that the stress testing processes used by the company are effective in meeting the requirements of the proposed rule. The proposed regulations indicate that the company’s policies and procedures must, at a minimum, outline the company’s stress testing practices and methodologies, validation, use of stress test results and processes for updating the company’s stress testing practices consistent with relevant supervisory guidance. The board of directors and senior management of each covered company and each over $10 billion company would have to approve and annually review the stress tests-related controls, oversight, documentation, policies and procedures.

As required under the statute, the proposed regulations would require each covered company and over $10 billion company to publish on its website or in some other form reasonably accessible to the public a summary of the results of its annual company-run stress tests within 90 days of submitting its stress test-related report to the Federal Reserve. Under the proposed regulations, the company-run stress test information that must be publicly disclosed would, at a minimum, include: (i) a description of the types of risks being included in the stress test; (ii) for each covered company, a high-level description of scenarios developed by the company for its additional stress test, including key variables used (such as GDP, unemployment rate, housing prices); (iii) a general description of the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon; and (iv) aggregate losses, pre-provision net revenue, allowance for loan losses, net income, and pro forma capital levels and capital ratios (including regulatory and any other capital ratios specified by the Federal Reserve) over the planning horizon under each scenario.

Debt-to-Equity Limit

Section 165(j) of the Dodd-Frank Act provides that a debt-to-equity ratio of not more than 15-to-1 must be maintained by a covered company with respect to which the FSOC has found that: (i) the company poses a grave threat to the financial stability of the United States; and (ii) the imposition of the debt-to-equity limit is necessary to mitigate that systemic risk. The proposed regulations clarify certain statutory terms and establish a timeline for compliance with the debt-to-equity limit following a notification of an FSOC determination under Section 165(j). The proposed regulations provide that a covered company would have 180 days following the receipt of a notification of the FSOC's determination to achieve a debt-to-equity ratio of no more than 15-to-1 with the possibility of up to two 90-day extensions. The debt-to-equity limit requirement would terminate as of the date the covered company receives notification from the FSOC that maintenance of the debt-to-equity ratio is no longer necessary.

Early Remediation Framework

Prior to the enactment of the Dodd-Frank Act insured depository institutions were subject to the so-called prompt corrective action ("PCA") framework. The financial crisis revealed the inadequacy of the PCA framework and prompted the inclusion of the early remediation requirements under Section 166 of the Dodd-Frank Act. Section 166 directs the Federal Reserve to promulgate regulations providing for early remediation of financial weaknesses at covered companies. In contrast to the PCA triggers, which are largely based on regulatory capital ratios, the proposed early remediation requirements would employ a range of triggers based on risk-based capital and leverage ratios, stress test results, certain market indicators, and compliance with the enhanced liquidity, risk management, and risk committee standards.

The proposed regulations establish four levels of remediation:

Level 1 Remediation

Heightened supervisory review, which would entail a targeted supervisory review of the covered company to evaluate whether the covered company is experiencing financial distress or material risk management weaknesses such that further decline of the covered company is probable and that the covered company should be subject to Level 2 remediation. This review must be completed within 30 days.

Level 2 Remediation

Initial remediation imposing restrictions on the covered company's capital distributions, assets growth, activities and acquisitions. A covered company subject to initial remediation: (i) shall not make capital distributions during any calendar quarter in an amount that exceeds 50 percent of the average of the covered company's net income in the preceding two calendar quarters; (ii) shall not permit its average risk-weighted and total assets to grow by more than 5 percent per quarter or per annum; (iii) shall not establish or acquire any office or acquire a controlling interest in any company without prior Federal Reserve approval; (iv) shall be subject to a non-public enforcement action by the Federal Reserve (e.g., memorandum of understanding); and (v) may be subject to limitations or conditions on the conduct of activities deemed appropriate by the Federal Reserve.

Level 3 Remediation

A covered company subject to Level 3 Remediation: (i) would be prohibited from making any capital distributions; (ii) shall not permit its average risk-weighted and total assets to grow; (iii) shall not acquire any interest in any company, establish or acquire any office, or engage in any new line of business; (iv) will be subject to a public enforcement action by the Federal Reserve specifying, among other things, that the company must raise additional capital; (v) shall not increase the compensation of, or pay bonuses to, its senior executive officers or directors; (vi) may be required to dismiss officers or directors, hold new board

elections, and/or hire senior executive officers approved by the Federal Reserve; and (vii) may be subject to more stringent inter-affiliate transactions restrictions.

Level 4 Remediation

Resolution assessment, which would entail a consideration of whether the covered company poses a risk to the stability of the US financial system. If the Federal Reserve determines that the covered company should be placed into receivership under Title II of the Dodd-Frank Act, the Federal Reserve shall make a written recommendation to that effect.

The proposed regulations would establish the following remediation triggers:

Capital and leverage

A covered company would be subjected to Level 1 remediation if the Federal Reserve determines that the company's capital structure, capital planning process, or the amount of capital it holds is not commensurate with the level and nature of the risks to which it is exposed, irrespective of the fact that the company is well-capitalized. Progressive levels of remediation would be triggered as the regulatory capital of the company deteriorates with Level 4 remediation triggered where the covered company's leverage, tier 1, and total risk-based capital ratios fall below 3 percent, 3 percent, and 6 percent, respectively.

Stress Tests

A covered company would be subject to Level 1 remediation if it is not in compliance any regulations relating to capital plans and stress tests. A covered company will be subject to Level 2 remediation if its tier 1 common risk-based capital ratio would be less than 5 percent but greater or equal to 3 percent under the severely adverse stress test scenario. If this ratio falls below 3 percent the covered company would be subject to Level 3 remediation.

Risk Management

A covered company would be subject to Level 1 remediation if it has "manifested signs of weakness" in complying with the enhanced risk management and risk committee requirements. If the covered company has "multiple deficiencies" in meeting the risk management and risk committee requirements, it would be subject to Level 2 remediation. Level 3 remediation would be triggered by "substantial noncompliance" with the enhanced risk management and risk committee requirements.

Liquidity

As with the risk management triggers, progressive levels of remediation would be triggered by "manifested signs of weakness," "multiple deficiencies," and "substantial noncompliance" with the enhanced liquidity management requirements.

Market Indicators

To implement the statutory requirement that remediation triggers include "other forward-looking indicators," the Federal Reserve proposes to specify a variety of market-based triggers designed to capture both emerging idiosyncratic and systemic risk. The Federal Reserve has not proposed specific market-based triggers in the proposed regulations and has indicated that it will publish for notice and comment the market-based triggers on an annual basis. Nonetheless, the Federal Reserve has described and requested comments on certain market indicators in the commentary to the proposed regulations, which include: (i) expected default frequency, which measures probability of default in the next 365 days; (ii) expected loss on equity given overall market decline by more than a certain amount; (iii) market equity ratio equal to the market value of companies' equity to market value of equity plus book value of debt; (iv) option implied volatility of the companies' stock price measured using an option pricing model; (v) credit default swaps against default on a 5-year maturity, senior unsecured bond of the company; and (vi) companies' subordinated bond spreads over the Treasury rate or LIBOR swap rate with the same maturity. Level 1 remediation would be triggered when the median value of at least one market-based indicator for a covered company crosses, over a specific period of time, a threshold based on a percentile or distribution relative to the past performance of the company and a specified

group of its peers. The proposed regulations indicate that the Federal Reserve would not use market-based triggers to directly subject a covered company to early remediation levels 2, 3, or 4 at this time, but would use the Level 1 heightened supervisory review to determine whether to elevate the covered company to a higher level of remediation.

The proposed regulations provide that the Federal Reserve shall notify covered companies upon initiation of each level of remediation and covered companies shall remain subject to the applicable remediation level requirements or restrictions until notified by the Federal Reserve that such requirements or restrictions no longer apply. Covered companies would also have an affirmative duty to notify the Federal Reserve of remediation triggers and changed circumstances that may affect the remediation requirements applicable to them.

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