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Enhanced Prudential Standards: The Federal Reserve's Proposal

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Shortly before year-end, the Federal Reserve Board ("FRB") proposed several rules to manage systemic risks presented by bank holding companies with consolidated assets of $50 billion or more and by nonbank financial institutions that are designated as systemically important by the Financial Stability Oversight Council ("FSOC").[1] The proposed regulation (the "Proposal") would implement the mandatory portions of sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").[2]

The Proposal includes seven sets of requirements for the bank holding companies over the $50 billion mark and the (to-be-designated) systemically important nonbanks (collectively, the "covered companies"): (i) risk-based capital requirements and leverage limits,[3] (ii) liquidity requirements, (iii) single-counterparty credit limits, (iv) risk management, (v) stress tests, (vi) the debt-to-equity ceiling, and (vii) early remediation.[4] Portions of the risk management and stress test provisions extend to banking organizations with less than $50 billion but more than $10 billion in consolidated assets.

Highlights

As a whole, Proposal reflects a fair reading of the Act and provides a level of detail that is a two-edged sword. On the one hand, the details in the Proposal are helpful for a covered company to measure its compliance with enhanced prudential standards. On the other hand, the specifics in many of the new standards, including those relating to capital planning by nonbank covered companies, liquidity, restrictions on single-counterparty exposures, mandatory stress-testing, and early remediation, will compel all but the very largest bank holding companies to revisit their risk management systems to ensure that all of the particular requirements have been covered. Areas that warrant careful attention include:

- *Capital planning by nonbank covered companies.* These companies must re-orient their financial planning to incorporate new quantitative requirements and to take account of all factors that inform capital adequacy.

- *Liquidity management*. The board of directors and senior management have explicit duties to monitor and manage liquidity, including the development of specific limits on liquidity risk. Certainly covered companies already oversee and address liquidity issues at a high level, but the existing governance structures may not satisfy all of the proposed new requirements.

- *Liquidity buffer and the underlying liquidity stress test*. The Proposal requires a liquidity buffer that anticipates the proposed liquidity coverage ratio under Basel III. The buffer will be composed of a limited number of highly liquid assets. The size of the buffer is to be determined by complex and virtually continuous stress tests. Covered companies typically have robust models for analyzing liquidity, but the Proposal places some critical parameters around the process that may require significant changes to those models.

[1] FRB, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012).
[2] Pub. L. No. 111-203, 124 Stat. 1376 (July 10, 2010). The Proposal does not purport to be exhaustive, and further rulemaking is likely since the Proposal does not address all of the FRB's authority under section 165.
[3] New capital and leverage requirements are not required for all systemically important financial institutions.
[4] Two other requirements in section 165 already have been the subject of rulemaking. Section 165(d) requires the submission of resolution plans and credit exposure reports by covered companies. In October 2011, the FRB finalized a new Regulation QQ that addresses resolution plans (12 C.F.R. part 243), 76 Fed. Reg. 67323 (Nov. 1, 2011). A proposed rule dealing with credit exposure reports, 76 Fed. Reg. 22648 (Apr. 22, 2011), remains pending.

- *Credit enhancements for single-counterparty exposures*. The Proposal has one set of explicit requirements and one implicit set of provisions. Explicitly, the Proposal identifies how a covered company at risk of exceeding exposure limits may avoid compliance issues through the use of credit mitigants. Implicitly, because not all forms of credit enhancement under the risk-based capital rules would qualify as mitigants for the credit risk presented by counterparties, the Proposal suggests that the FRB could begin to take a narrower view of credit enhancements.

- *Double stress-testing*. As directed by Dodd-Frank, the Proposal requires that both covered companies and the FRB conduct stress tests of the covered companies. Two aspects of the double-testing are important. First, because the tests use essentially the same inputs, the FRB test functions as a test of the validity of a covered company's testing process. Second, the Proposal requires that detailed stress test results be made public on a company-specific basis, which could lead to a variety of adverse market responses to the point that the responses to stress test results could create their own stress conditions for a company. The Proposal's public disclosure requirement, however, is not required by Dodd-Frank.

- *Early remediation*. Although the substance of the early remediation regime may not differ in material respects from how the FRB currently supervises large bank holding companies under stress, the Proposal identifies several cause-and-effect scenarios that may result in harsher FRB responses to troubled institutions than has previously been the case.

In addition to these core issues, the Proposal discusses a few specific points that could have important operational consequences.

- *Capital*. Capital adequacy is one of the highest priorities in bank supervision. For bank holding companies, however, the Proposal does not break new ground in this area. The Proposal does signal that the FRB will adopt the Basel III standards. The Proposal does not address the suggestion of at least one FRB governor that, in the course of reviewing proposed capital distributions and capital plans, the FRB will apply these standards. At the same time, the FRB proposes to require covered nonbank companies to comply with the regulatory capital standards that currently apply to bank holding companies, a requirement that may pose significant operational and compliance challenges for some, if not all, covered nonbank companies.

- *Companies that are not large U.S. bank holding companies*. The Proposal treats these institutions in different ways. Foreign bank organizations ("FBOs") are excluded,[5] as are, for most purposes, savings and loan holding companies.[6] However, in addition to the covered companies, other institutions—bank and thrift holding companies with more than $10 billion in consolidated assets—are by statute subject to stress-test and risk committee requirements. The FRB observes that it

[5] The FRB notes that it will propose an enhanced framework for FBOs shortly. In applying enhanced standards, the FRB is required by section 165(b)(2) 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 financial company is subject on a consolidated basis to home country standards that are comparable to U.S. standards. The FRB has exempted FBOs from the Proposal because of international agreements that do not contemplate all of the requirements in the Proposal, different home country approaches to bank supervision, diverse structures in the U.S., and wide variance in risk to U.S. financial stability.

[6] Before issuing new capital and stress testing standards, the FRB must develop consolidated capital requirements for SLHCs.

has authority to apply enhanced standards to bank holding companies with less than $50 billion in consolidated assets, but the Proposal does not attempt to do so, apart from the statutory requirements.

- *Foreign sovereign debt*. These instruments cannot be included in the "liquidity buffer"—the pool of assets each covered company must maintain for short-term liquidity. The limits on credit exposure to a single counterparty apply to investments in sovereign debt.

- *Fannie Mae and Freddie Mac securities*. For "policy" reasons, this debt may be included in the liquidity buffer, although it must be discounted to reflect credit risk and volatility. The single-counterparty credit exposure limits do not apply to mortgage-backed securities issued by either of these two entities while they are operating under conservatorship.

Overview

A core system regulation requirement of Dodd-Frank is that the FRB establish prudential standards for the largest banking institutions that are more stringent than those that apply to smaller banks. The stated purpose of these enhanced requirements is to prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions. Another purpose of these standards is, in the FRB's words, "to provide incentives for covered companies to reduce their systemic footprint."

The Proposal marks the formal beginning of the standard-setting process. More will follow, including standards for FBOs and SLHCs. Section 165 authorizes the FRB to tailor standards, taking into consideration the capital structure, riskiness, complexity, financial activities (including activities), size, and any other risk factors that the FRB deems appropriate. Throughout the Proposal, the FRB notes that it will apply particular standards according to these factors, referred to by the FRB as the "systemic footprint" of a covered company. With respect to nonbank financial companies subject to enhanced standards, the FRB will assess the business model, capital structure, and risk profile of the company. Dodd-Frank does not provide for tailoring in all cases: the capital requirements in the Collins Amendment, section 171 of Dodd-Frank, apply equally to nonbank financial companies deemed systemically important as they do to bank holding companies over the $50 billion threshold.

The dates for compliance with the enhanced standards are not uniform. Although section 165 does not set a uniform compliance date, the Proposal provides two dates for compliance with most requirements in the Proposal. For companies that are covered companies on the effective date of the final rule, the deadline is the first day of the fifth full calendar quarter following the effective date. The deadline for companies that become covered after the effective date—either because they have been designated as systemically important by the FSOC or because as bank holding companies they have grown to more than $50 billion in consolidated assets—is the first day of the fifth full calendar quarter following the date on which they become covered. The compliance dates are different, however, for the enhanced risk-based capital and leverage requirements, the limits on single counterparty credit exposures, and stress testing.

The Proposal places the enhanced prudential standards in a new Regulation YY (12 C.F.R. part 252). We review each of the substantive subparts below in the order of their appearance in Regulation YY.

Risk-based Capital and Leverage (Subpart B)

The Proposal extends the existing capital requirements for covered bank holding companies to nonbank covered companies. A nonbank covered company must calculate total and Tier 1 risk-based capital and leverage ratios in the same way that bank holding companies do now. The nonbank covered company also must meet the same minimum capital requirements: four percent Tier 1 risk-based capital, eight percent total risk-based capital, and four percent leverage. Whether the balance sheet of every nonbank covered company can accommodate these requirements is an open question; the FRB requests comment on whether nonbank covered companies should be held to the same minimum capital requirements as bank holding companies.

The Proposal does not otherwise set forth new, quantitative capital requirements for all covered companies. The FRB's discussion in the Proposal[7] describes a two-part process for implementing enhanced risk-based capital and leverage standards for covered companies.

First, nonbank covered companies will be subject to certain regulatory capital requirements and to the same new rules that require bank holding companies with assets of more than $50 billion to file capital plans and to conduct stress tests.[8] With respect to capital standards, these companies must calculate their minimum risk-based and leverage capital requirements in accordance with the rules for bank holding companies. The companies also must hold capital sufficient to meet tier 1 and total risk-based capital ratios of four percent and eight percent, respectively, as well as a tier 1 leverage ratio of four percent. These requirements take effect on the later of the effective date of the final rule or 180 days after the date on which the FSOC determined the company to be systemically important and therefore subject to supervision by the FRB.

With respect to capital planning, the core requirement is that a plan demonstrate that the covered company is able to maintain a Tier 1 common equity ratio of at least five percent, as well as meeting all other minimum capital requirements, under both expected and stressed conditions over a nine-month planning horizon. The plan also must explain how the company will be able to continue operations during times of economic and financial stress. Much of the plan will depend on and incorporate the results of the covered company's internal stress tests. The stress tests will rely on financial data as of September 30 and on three sets of economic assumptions provided by the FRB in mid-November. A covered company must then complete its stress test and finalize the capital plan in time for submission to the FRB on January 5. The FRB will evaluate the plan, using the results of the company's own stress tests and the results of the FRB's own stress tests. The FRB will provide comments to the company by the end of March. The company then may be required to make changes to the capital plan; these changes must be completed within 30 calendar days.
In addition, the capital plan regulation requires, in some cases, advance FRB approval of capital distributions.

The date on which a covered company must begin to comply with the capital planning and stress testing requirements depends on the time period between the date on which the FSOC subjected the company to FRB supervision and September 30. September 30 is the reference date because both the capital plan and the stress tests use financial data as of that date. If a company has been designated as systemically important no less than 180 days

[7] The FRB's discussions or explanations of the enhanced prudential standards are located in the Supplementary Information portion of the Proposal.
[8] 12 C.F.R. § 225.8. *See* 76 Fed. Reg. 74631 (Dec. 1, 2011).

before September 30 in a calendar year, then the company must comply with the capital planning and stress testing requirements from September 30 of that year and thereafter. By inference, if the designation is made less than 180 days before September 30, then the compliance date is September 30 of the following year.

Second, the FRB will, probably in 2014, introduce a quantitative risk-based capital surcharge for "some or all" covered companies, based on the Basel III capital surcharge framework for globally systemically important banks ("G-SIBs").[9] The Basel III framework would impose surcharges in five tiers ranging from 100 to 350 basis points on approximately 30 G-SIBs. A particular G-SIB would be assigned to one of the four lower tiers (the fifth would be left empty for the time being) based on an assessment of twelve factors. The surcharge would phase in between 2016 and 2019. The G-SIBs and their assignments, however, have not been finally determined. The G-20 recently identified 29 G-SIBs, of which eight are covered companies. 26 other U.S. bank holding companies are not G-SIBs but are covered companies, and the FRB will have to make a decision on whether to impose a surcharge on them.

In its discussion of the Proposal, the FRB observes that other Basel III requirements other than the surcharge on G-SIBs and including generally higher capital requirements, a common equity requirement, conservation and countercyclical buffers, and a leverage standard (at least for internationally active banking entities), are under discussion and will be the subject of future FRB rulemakings. Given the length of the Basel III process and the emergence of some requirements already, most of the bank covered companies already will have begun to take these requirements into account in their capital planning. These requirements will present a greater challenge to nonbank covered companies as they are designated systemically important.[10]

The FRB appears to be planning a tiered approach to higher capital requirements—indeed, section 165(a)(2) encourages doing so—but the Proposal does not provide any substantive guidance on how the FRB might draw the lines in this area.

[9] The FRB refers to the Basel document published in November 2011 that describes the surcharge. *See* BCBS, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement (Nov. 2011), available at http://bis.org/publ/bcbs208.htm.

[10] The Proposal contains a 180-day grace period for nonbank covered companies that are designated as systemically important after the effective date of Regulation YY. There is no such period for any institution so designated before the effective date.

Liquidity (Subpart C)

The Proposal requires a far-reaching liquidity management program; several provisions are intended to increase in stringency as the systemic footprint of a covered company widens.[11] The program has at least seven elements. The timing of compliance with all of these elements is subject to the presumptive first-day-of-the-fifth-quarter rule.

Corporate governance (12 CFR 252.52 - .54)

The Proposal places extensive and specific obligations on the board of directors in overseeing liquidity. Each covered company will need to take care that the board addresses these duties and documents its decision-making. Certain of the duties, but not necessarily all, may be carried out by a risk committee. We discuss the formation of the risk committee below, in connection with subpart E of the proposed Regulation YY.

The board is required to make the following decisions or take the following actions:

- Review and approve the liquidity risk management strategies, policies, and procedures established by senior management.

- On at least an annual basis, establish the company's liquidity risk tolerance. In doing so, the board must consider the company's capital structure, risk profile, complexity, activities, size, and any other appropriate risk-related factors.

- On at least a semi-annual basis, review information provided by senior management to determine whether the company is managed in accordance with the established liquidity risk tolerance.

- On at least an annual basis, review and approve the contingency funding plan. Review and approval is required as well whenever material revisions are made to the plan.

This risk committee (or a designated subcommittee) must undertake the following:

- Review and approve the liquidity costs, benefits, and risks of each significant new business line and each significant new product. The review and approval must take place before the company implements the new line or offers the new product. The analysis must include consideration of the liquidity risk of the new business line under current conditions and under liquidity stress. This risk must be within the liquidity risk tolerance established by the board.

- At least annually, review significant business lines and products to determine whether any has created unanticipated liquidity risk and whether the liquidity risk of each remains within the company's liquidity risk tolerance.

- On at least a quarterly basis, conduct the following oversight tasks:

  - Review the cash flow projections (discussed below) for time periods beyond 30 days to ensure that liquidity risk is within the established tolerance.

[11] Provisions to be tailored based on systemic footprint include the liquidity risk tolerance, the amount of detail provided in cash flow projections, liquidity stress testing, the size of the liquidity buffer, the contingency funding plan, and specific limits on potential sources of liquidity risk.

- Review and approve liquidity stress testing, including practices, methodologies, and assumptions. Review and approval also must take place whenever material revisions are made to the tests.

- Review the liquidity stress testing results.

- Approve the size and composition of the liquidity buffer.

- Review and approve the specific limits on liquidity risk (described below).

- Review liquidity risk management information necessary to identify, measure, monitor, and control liquidity risk and otherwise to comply with subpart C.

* On a periodic basis, review the independent validation of the liquidity stress tests.

* Establish procedures governing the content of senior management reports on the company's liquidity risk profile.

The FRB expects the periodic liquidity reviews and approvals to occur more frequently as market and idiosyncratic conditions warrant.

Senior management has inherent responsibility, of course, to manage the company in accordance with the decisions and recommendations of the board and the risk committee and with regulatory requirements. The Proposal identifies two aspects of these obligations; management should in turn ensure that its actions are appropriately documented. Senior management must:

* Establish and implement strategies, policies, and procedures for managing liquidity risk. This responsibility includes oversight of all of the substantive elements of subpart C—liquidity risk management and reporting systems, cash flow projections, liquidity stress testing, the liquidity buffer, the contingency funding plan, specific limits on liquidity risk, and monitoring these procedures.

* Regularly report to the risk committee (or its designated subcommittee) on the company's liquidity risk profile, as well as providing other necessary information to the board or the risk committee.

In addition to specifying duties of the board, risk committee, and senior management, the Proposal requires a covered company to establish an independent review function of liquidity risk management. This unit will have three responsibilities: on at least an annual basis, to review and evaluate the adequacy and effectiveness of such management; to assess compliance with both regulatory and internal requirements; and to report any noncompliance or material risk management issues to the board or the risk committee. The function must be independent of the management functions that execute funding, but otherwise the precise placement of the unit is within the company's discretion.

Liquidity buffer (12 CFR 252.57)

The one quantifiable element of the liquidity risk management process outlined in the Proposal is the liquidity buffer. The size of the buffer is based predominantly on two underlying analyses—cash flow projections and liquidity stress-testing—as well as on the company's systemic footprint. Before turning to these processes, it is helpful to consider the instruments includable (and not includable) in the buffer.

The asset pool that constitutes the buffer is limited to highly liquid and unencumbered assets that are sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios.[12] The pool must be diversified by instrument type, counterparty, geographic market, and other liquidity risk identifiers. Discounts will be applied to reflect market volatility and credit risk.

While the language of the proposed regulation is general, the FRB's discussion of the buffer is specific. Eligible highly liquid assets are limited to cash, U.S. Treasuries, and other securities issued or guaranteed by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity. Notably, this portfolio would include debt issued by Fannie Mae and Freddie Mac. Non-U.S. sovereign debt and any debt issued by state or local governments in the U.S., however, are excluded. The FRB may approve other "flight-to-quality" assets for inclusion in the buffer (e.g., "plain vanilla" senor corporate debt) but only if they have low credit risk and low market risk, are traded in an active secondary two-way market with certain features,[13] and historically have been purchased by investors in periods of financial distress during which market liquidity has been impaired.[14]

A highly liquid asset also must be unencumbered: it cannot be pledged, be used to secure, collateralize, or provide credit enhancement to any transaction, be subject to any lien or be subject to any legal or contractual restrictions on the company's ability to promptly liquidate, sell, transfer, or assign the asset. An asset designated as a hedge on a trading position is ineligible. An asset will be so designated if it is held in order to directly offset the market risk of another trading asset or group of trading assets, e.g., a corporate bond held in order to hedge a position in a corporate bond index.

Cash flow projections (12 CFR 252.55)

A detailed set of cash flow projections, both short- and long-term, is required. The Proposal calls for a robust methodology and reasonable assumptions, all of which must be documented. The projections should be dynamic rather than static and must take account of the flows resulting from assets, liabilities, and off-balance sheet exposures, as well as from contractual maturities and from new business, funding renewals, customer options, and other potential events that could affect liquidity. The projections must identify cash flow mismatches as well. The projections also must reflect the company's systemic footprint, which could entail projections at business line, legal entity or jurisdiction levels and the use of additional time horizons. The short-term projections must be updated daily and the long-term projections monthly.[15]

Liquidity stress testing (12 CFR 252.56)

On a monthly basis, a covered company must stress-test its cash flow projections. Given the complexity of these tests, a covered company effectively will be testing liquidity continuously. The testing is expected to follow the principles set forth in proposed guidance on stress

[12] The buffer requirement is comparable to the liquidity coverage ratio ("LCR") now under review in the Basel III process. The FRB indicates that it will adopt the final Basel III LCR, as well as its companion, the net stable funding ratio.
[13] A qualifying market must have observable market prices, committed market makers, a large number of market participants, and a high trading volume.
[14] Compelling the largest participants in the capital markets to re-focus their investment strategies on a limited number of instruments will, for better or worse, drive up the price of those instruments and may well exacerbate the liquidity issues surrounding other instruments.
[15] The format of the projections is set forth in note 66 to the Proposal, 77 Fed. Reg. 608.

testing that was released in June 2011.[16] The company must use the results of the stress tests to determine the size of its liquidity buffer and must incorporate the results in the quantitative assessment component of its contingency funding plan. The Proposal does not specify the methodology for the tests, but it imposes four sets of requirements. A company must:

- Incorporate a range of stress scenarios that in turn take into consideration at least the company's balance sheet exposures, off-balance sheet exposures, business lines, and organizational structure. The scenarios are required to:

  - Account for market stress, idiosyncratic stress, and combined market and idiosyncratic stresses.

  - Address the potential impact of market disruptions on the company.

  - Address the potential actions of other market participants experiencing liquidity stresses under the same market disruptions.

  - Be forward-looking and incorporate a range of potential changes in the company's activities, exposures, and risks, as well as changes to the broader economic and financial environment.

  - At a minimum, include four time horizons: overnight, 30 days, 90 days, and one year. The FRB could require additional horizons.

- Address in a comprehensive manner, the company's activities, exposures, and risks, including off-balance sheet exposures.

- Be tailored to, and provide sufficient detail to reflect the company's systemic footprint. Accordingly, analyses by business line, legal entity, or jurisdiction may be necessary.

- Incorporate four conditions:

  - Only assets in the liquidity buffer—i.e., unencumbered, highly liquid assets—are available to meet funding needs in the first 30 days.

  - After 30 days, other "appropriate" funding sources may be added to the buffer assets for use as cash flow.

  - Any asset treated as a funding source must be discounted to reflect market risk and volatility.

  - Liquid assets (other than cash and securities issued by the U.S. government, a U.S. government agency, or a U.S. government sponsored entity) must be diversified by collateral, counterparty, borrowing capacity, or other liquidity risk identifiers.

Because of the frequency of the testing and the volume of data to be tested, a covered company must have in place an extensive risk management framework. A covered company

[16] See 77 Fed. Reg. 599 n.32. The proposal in June goes beyond liquidity stress-testing and covers testing for all risk management purposes.

must maintain management information systems and data processes sufficient to enable a company to effectively and reliably collect, sort, and aggregate data and other information relating to stress testing. Policies and procedures must outline the testing practices, methodologies, and assumptions, detail the use of each stress test, and provide for the enhancement of stress testing practices as risks change and techniques evolve. Oversight of the testing process must be sufficient to ensure that each test is designed in accordance with section 252.56 and that the stress process and assumptions are validated. Validation may be conducted internally but must be independent of the liquidity stress-testing functions and of the functions that execute funding.

Contingency funding plan (12 CFR 252.58)

A contingency funding plan is described by the FRB as a compilation of policies, procedures, and action plans for managing liquidity stress events. The plan is required to set out a covered company's strategies for addressing liquidity needs during liquidity stress events. A plan must be updated at least annually and more frequently as market and idiosyncratic events warrant. The plan must have four components:

- Identification of stress events. This part incorporates information from liquidity stress testing. This part will consist of quantitative assessments of the impact of identified stress events on liquidity and of available funding sources (including alternative sources) during these events. Four specific types of information are necessary for this component of the contingency plan.

    - A company must identify stress events with significant effects on liquidity. These events could include deterioration in asset quality, rating downgrades, widening of credit default swap spreads, operating losses, declining financial institution equity prices, and negative press coverage.

    - The plan must assess the level and nature of the impact of various levels of stress severity, various stages for each type of event. There is no time period for disruptions; the plan should cover temporary, intermediate term and long-term events. This assessment should be used to design early warning indicators, assess potential funding needs, and to specify action plans.

    - The plan also must assess available funding sources and needs. This assessment requires an analysis of the potential loss of funding at various points in the stress event and the identification of cash flow mismatches. The FRB expects a realistic analysis of the company's cash inflows, outflows, and funds availability at different time intervals, which will enable the company measure its ability to fund operations.

    - The company must identify alternative funding sources. Discount window borrowing is acceptable, but the FRB implies that only primary credit (which is limited to healthy institutions and must be collateralized) will qualify. If a company does rely on the discount window, it must include a plan to replace this borrowing with permanent funding. The FRB expects procedures and agreements with alternative lenders to be in place before there is a need to access this funding.

- Event management process. This process involves an action plan for responding to liquidity shortfalls during stress events (including accessing alternative funding sources), an identified "liquidity stress event management team," an explanation of how the company will invoke the plan, and a mechanism for communications internally and with the FRB, other regulators, counterparties, and other stakeholders.

- Monitoring. A covered company must be able to identify early warning indicators and other means of monitoring stress events. Indicators may include negative publicity concerning an asset class owned by the company, potential deterioration in the company's financial condition, widening debt or credit default swap spreads, and increased concerns of the funding of off-balance sheet items.

- Testing. The plan must provide for the periodic testing. Trial runs are necessary, with simulations to evaluate communications, coordination, and decision-making by the relevant managers. Additionally, a covered company is required to test the availability of alternative funding and its ability to access collateral to secure additional borrowing.

Specific limits (12 CFR 252.59)

The board is required to set several limits on the sources of liquidity risk. Even for large bank holding companies, the extent of the specific limits may go beyond those that an institution historically has set. The mandated limits must cover:

- Concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and any other liquidity risk identifiers.

- The amount of specified liabilities that mature within various time horizons.

- Off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.

Monitoring (12 CFR 252.60)

The Proposal requires a covered company to establish and maintain procedures for monitoring four different items:

- The assets already pledged and unencumbered assets available to be pledged as collateral. The company must be able to calculate "in a timely manner" the value of its existing collateral positions relative to contractual requirements. Collateral monitoring also must cover levels of available collateral by legal entity, jurisdiction, and currency exposure; shifts between intraday, overnight, and term pledging of collateral; the operational and timing requirements associated with accessing collateral at its physical location.

- Liquidity risk exposures and funding needs within and across business lines, legal entities, and jurisdictions, and intraday positions. A covered company must maintain sufficient liquidity for each significant legal entity in light of any restrictions on the transfer of liquidity between legal entities.

- Intraday liquidity positions. These procedures must cover the monitoring of daily gross liquidity inflows and outflows, the use of collateral when necessary to obtain intraday credit, the prioritization of time-sensitive obligations, the ability to settle "less critical" obligations, controls on the issuance of credit where necessary, and the amounts of collateral and liquidity necessary to meet payment systems obligations. The FRB observes that the monitoring of these positions is generally an operational risk function, and a covered company accordingly will need to develop an integrated procedure for both operational and liquidity risk.

- Compliance with the liquidity limits set by the company.

The FRB expects that, in order to conduct this monitoring, a covered company will need processes that aggregate data across multiple systems to develop an enterprise-wide view of liquidity risk management and to identify constraints on transferring liquidity within the organization.

Documentation (12 CFR 252.61)

A covered company has broad obligations to document all material aspects of its liquidity risk management process and its compliance with subpart C and to submit all of this documentation to the risk committee. In addition, a company must provide to the committee, the methodologies and material assumptions included in cash flow projections and liquidity stress tests, and all elements of the contingency funding plan. This material will be available to the FRB on request.

Single-counterparty Credit Exposure Limits (Subpart D)

Section 165(e) caps the credit exposure of a covered company to any unaffiliated company at 25% of the covered company's capital and surplus[17] and authorizes the FRB to impose stricter limits. This rule forms the basis for a more detailed set of restrictions in the Proposal.

Two limits (12 CFR 252.93)

The Proposal contains two limitations. First, it largely re-states the provision in section 165(e):

> No covered company shall, together with its subsidiaries, have an aggregate net credit exposure to any affiliated counterparty that exceeds 25 percent of the consolidated capital stock and surplus of the covered company.[18]

In addition, credit exposures between "major" covered companies are capped at 10% of capital and surplus. This stricter rule applies only when both companies to the transaction are covered companies that are "major" in size. The limit is as follows:

> No major covered company shall, together with its subsidiaries, have aggregate net credit exposure to any unaffiliated counterparty that is a major counterparty that exceeds 10 percent of the consolidated capital stock and surplus of the major covered company.[19]

Each word or phrase is critical in understanding the scope of the rule. We discuss most of the terms immediately below but thereafter discuss the meaning of "net credit exposure." Determining a net credit exposure is a two-step process involving determination of "gross credit exposure" and then making various deductions or other modifications. Additionally, bear in mind is that section 165(e) has its own effective date that differs from the dates for all other provisions in section 165, and it may be difficult to determine exactly what date applies to some covered companies. The dates are discussed below in connection with compliance.

Definitions (12 CFR 252.92)

Important definitions, other than credit exposure, are as follows, in order of their appearance in the Proposal.

- Aggregate net credit exposure. This term means the sum of all net credit exposures of a covered company to a single counterparty.

- Credit transaction. This term underlies the definition of credit exposure and broadly encompasses virtually any agreement that exposes a covered company to credit risk. In full, the term includes: any extension of credit to a counterparty, including loans, deposits, and lines of credit, but excluding advised or other uncommitted lines of

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[17] § 165(e)(2); 12 U.S.C. § 5365(e)(2). This limit differs from the restrictions placed on insured depository institutions for loans to one borrower under 12 U.S.C. § 84 and related statutory provisions. The bank-level limits are stricter: there is a 25% limit (measured against the same capital that covered companies must use) on certain credit exposures, but 10% of these exposures must be fully secured. Over time, various exceptions have been grafted onto the bank-level rules; these interpretations overlap with but do not match up against the exceptions in the Proposal.

[18] 12 C.F.R. § 252.93(a).

[19] 12 C.F.R. § 252.93(b). A sovereign government (including the U.S.) is a counterparty for the purpose of this rule.

credit; any repurchase or reverse repurchase agreement with the counterparty; any securities lending or securities borrowing transaction with the counterparty; any guarantee, acceptance, or letter of credit (including any confirmed letter of credit or standby letter of credit) issued on behalf of the counterparty; any purchase of, or investment in, securities issued by the counterparty; any credit exposure to the counterparty in connection with a derivative transaction between the covered company and counterparty; any 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 of the counterparty; and any transaction that is the functional equivalent of the above, and any similar transaction that the FRB determines to be a credit transaction for purposes of the credit exposure rule.

- Counterparty. A counterparty includes the typical parties with which a covered company might enter into a credit transaction: a natural person and members of the person's immediate family and a company and all of its subsidiaries. The treatment of government entities warrants particular attention. The term also encompasses sovereign entities: the U.S. government, State governments, foreign sovereign entities, and all of their agencies, instrumentalities, and subdivisions. Additionally, as noted in the discussion of exemptions below, exposures to the U.S. government and its agencies or to Fannie Mae and Freddie Mac are not subject to the single-counterparty credit exposure limits, notwithstanding the inclusion of these entities in the definition of counterparty.

- Covered company. This term has the same definition used for other provisions in the Proposal, but a single credit exposure limit applies to the net credit exposures of a covered company "together with" its subsidiaries. The Federal Home Loan Banks are not covered companies.

- Major covered company. This term encompasses any bank holding company with total consolidated assets equal to or greater than $500 billion[20] and any nonbank covered company (regardless of asset size).

- Subsidiaries. A covered company's subsidiaries include any company controlled directly or indirectly by the covered company. "Control" is defined more narrowly than in the Bank Holding Company Act. One company controls another for the purposes of the single counterparty credit exposure limits when the company owns, controls, or holds with the power to vote 25 percent or more of a class of voting securities or owns or controls 25 percent of the total equity of the other company, or when the company consolidates the other for financial reporting purposes. Other arrangements that in other contexts would constitute control—e.g., ability to elect a majority of the board or to control a general partner—do not create control under the credit exposure limits.

- Unaffiliated counterparty. This term is not specifically defined, but reasoning from the definition of affiliate, it is a counterparty that does not control, is not controlled by, and is not under company control with the covered company.

[20] The asset amount is determined on the basis of the average of the company's total consolidated assets in the four most recent quarters as reported quarterly on the company's FR Y-9C.

Gross credit exposure (12 CFR 252.94)

"Net credit exposure" is determined through a two-step process. First, a covered company must determine its "gross credit exposure" to a counterparty.[21] The Proposal recognizes several different types of credit transactions to be included in this calculation. Different valuation methods apply. The types of credit transactions, together with the appropriate valuation method, are as follows:

- Extensions of credit to the counterparty, including loans, deposits, lines of credit, and leases, are valued at the amount owed by the counterparty to the covered company. Committed credit lines are valued at their face amount. Advised or other uncommitted lines of credit are excluded.

- Debt securities issued by the counterparty are valued in different ways. For securities traded and available for sale, the value is the greater of the amortized purchase price or market value; for securities held to maturity, the amortized purchase price.

- Equity securities issued by the counterparty are valued at the greater of the purchase price or market value.

- Repurchase agreements are equal to the market value of the securities transferred by the company to the counterparty plus the product of multiplying the market value by the same "haircut" required for collateral. The Proposal includes a table of haircuts. For example, a bond traded on the Standard & Poor's 500 index with a current market value of $100 would be haircut by 15% when provided as collateral. Conversely, when part of a repurchase agreement, the credit exposure is an additional 15%, and the total exposure would be $115. The FRB requires the add-on to capture market volatility.

- Reverse repurchase agreements are equal to the amount of cash transferred by the covered company to the counterparty.

- Securities borrowing transactions are valued at the amount of cash collateral plus the market value of securities collateral transferred by the covered company to the counterparty.

- Securities lending transactions are equal to the market value of the securities lent to the counterparty, plus the product of multiplying the market value amount by the appropriate haircut (the same calculation used for repurchase agreements).

- Guarantees, acceptances, or letters of credit (including any confirmed letter of credit or standby letter of credit) issued by the company on behalf of a counterparty are valued at the lesser of the face amount or the maximum potential loss to the company on the transaction.

- Derivative transactions that are subject to a qualifying master netting agreement are valued at the exposure-at-default amount calculated under the advanced risk-based capital guidelines. The amount of any initial margin and excess variation margin posted to a counterparty also is included. If a derivative is cleared through a central

[21] 12 C.F.R. 252.94(a).

counterparty ("CCP"), then any contribution to the CCP's guaranty fund is an exposure and is valued at the notional amount.

- Derivative transactions between a company and a counterparty that are not subject to a qualifying master netting agreement are valued at an amount equal to the sum of (i) the current exposure of the derivatives contract equal to the greater of the mark-to-market value of the contract or zero and (ii) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the contract by the appropriate conversion factor (the Proposal includes a matrix of conversion factors).

- Credit or equity derivative transactions between the covered company and a third party where the company is the protection provider and the reference asset is an obligation or equity security of the counterparty are equal to the lesser of the face amount of the transaction or the maximum potential loss to the company on the transaction.

Two important provisions apply when summing up exposures for the purpose of applying the limits. First, a single limit applies to the sum of the exposures of a covered company and its subsidiaries. Even if a covered company itself—e.g., a shell holding company—does not extend credit, all of the exposures of all of its subsidiaries will be added together in order to determine whether the covered company is in compliance with the limits. An attribution rule also applies: a transaction with any person is a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of or transferred to the person.[22] Such a person need not be a party to the credit agreement between the covered company and the initial counterparty.

Net credit exposure (12 CFR 252.95)

Once a covered company determines its gross credit exposure, it must take the second step, making adjustments to account for credit risk mitigants. In general, as the FRB explains, these mitigants consist of eligible collateral, eligible guarantees, eligible credit and equity derivatives, other eligible hedges, and, for securities financing transactions, bilateral netting agreements. Whether the Proposal has captured the universe of effective mitigants may be an issue for discussion during the comment period. One apparent omission concerns simple credits held by both a covered company and a counterparty that could be set off against each other for state law purposes. Legal set-offs do not appear to constitute an adjustment under the Proposal. The adjustments in the Proposal are as follows:

- *Netting arrangements in securities financing transactions*. For repurchase and reverse repurchase exposures subject to a bilateral netting agreement, a covered company may use the associated net credit exposure. The same rule applies to securities lending and borrowing transactions.

- *Eligible collateral*. An exposure may be reduced by the adjusted market value of "eligible collateral," after application of the appropriate haircut, subject to three conditions to insure that the collateral reduces the exposure only to the counterparty providing the collateral.[23]

[22] Note that this rule is narrower than the attribution rules in Regulations O and W.
[23] The conditions are (i) that the company use the adjusted market value of the collateral in calculating its gross credit exposure to the issuer of the collateral; (ii) that the collateral cannot be used to adjust the covered company's gross credit exposure to any other counterparty; and (iii) that the covered company's

"Eligible collateral" includes cash on deposit with a covered company, debt securities (other than mortgage- or other asset-backed securities) that are bank-eligible, and publicly traded equity securities and convertible bonds. All forms of collateral other than cash are subject to a haircut; the largest haircuts are on equity securities and convertible bonds. Collateral is eligible only if the covered company has a perfected, first-priority security interest (or the equivalent for collateral outside the U.S.) in the collateral.

- *Unused portions of credit commitment*. These portions may be deducted from a gross credit exposure—but only if the covered company has no legal obligation to advance additional funds until the borrower provides the amount of adjusted market value of collateral required with respect to the entire used portion of the extension of credit. The credit contract must limit such collateral to cash, obligations of the U.S. or its agencies, and securities backed by Fannie Mae or Freddie Mac (for as long as a conservator or receiver is in place). The FRB also may allow other obligations of U.S. government-sponsored enterprises to be used as collateral. Note that if a commitment could become legally enforceable for reasons other than the provision of collateral, then this commitment cannot be used to reduce gross credit exposure.

- *Eligible guarantee*. A guarantee from an "eligible protection provider" may be used to reduce gross credit exposure. Eligible providers include sovereign entities, certain international financial groups, certain government-sponsored entities (but not Fannie Mae or Freddie Mac), and financial institutions, including foreign banking organizations.[24] A covered company must, however, treat the guarantee as an exposure to the provider. The FRB has imposed this requirement in order to limit the ability of a covered company to extend credit to a large number of high risk borrowers that are guaranteed by a single guarantor. The value of this exposure cannot exceed the value of the exposure to the original counterparty.

- *Eligible credit or equity derivative*. A covered company also must reduce its gross credit exposure by the notional amount of any eligible credit or equity derivative that has been written by an eligible protection provider that references the counterparty (subject to certain conditions). In order to be eligible, a credit derivative must be in simple form, including single-name or standard, non-tranched index credit derivatives. An equity derivative includes only an equity-linked total return swap and not other more complex equity derivatives, such as purchased equity-linked options. A covered company must treat the amount by which a derivative has reduced exposure to a counterparty as an exposure to the protection provider.

- *Short sales*. A short sale of a counterparty's debt or equity security may be used as a hedge to reduce the amount of the exposure.

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gross credit exposure to the issuer of the collateral must be less than its gross credit exposure to the counterparty on the credit transaction.

[24] The term includes any sovereign entity; the Bank for International Settlements, the International Monetary Fund, the European Commission, or a multilateral development bank; a Federal Home Loan Bank; the Federal Agricultural Mortgage Corporation; a depository institution; a bank holding company; a savings and loan holding company; a registered securities broker or dealer; an insurance company to supervision by a state insurance regulator; a foreign banking organization; a non-U.S.-based securities firm or insurance company that is subject to consolidated comparable supervision; and a qualifying central counterparty.

Compliance and timing (12 CFR 252.91, .96)

The Proposal requires that a covered company track compliance as of the end of each business day and submit a monthly compliance report to the FRB.

If a covered company falls out of compliance either because its capital has declined (thus reducing the denominator and increasing the percentage of capital represented by the credit transactions with a counterparty or because of mergers of the covered company with another covered company or of two counterparties, the company will have a 90-day period in which it must make reasonable efforts to return to compliance. During the 90 days, a covered company may not enter into similar transactions with the same counterparty, unless the FRB finds that the transactions are necessary to preserve safety and soundness of the company or U.S. financial stability. In making this determination, the FRB will consider any decrease in the covered company's capital stock and surplus, and mergers involving either the covered company and another such company or two unaffiliated counterparties. During the 90-day compliance period, the company must comply with all applicable restrictions on a daily basis and must submit a monthly report that demonstrates daily compliance.

The dates for compliance with the single-counterparty exposure rules are difficult to determine, and the language in the proposed rule may not reflect the intent of the FRB. Section 165(e)(7)(A) clearly provides that these rules take effect on July 21, 2013. As written, the proposed regulation recognizes three categories of covered companies: (i) companies that are covered companies on the effective date, July 21, 2013; (ii) companies that become covered after the effective date but before September 12, 2012; and (iii) companies that become covered companies after July 21, 2013. Since the effective date is after September 12, 2012, category (ii) is a null set. A category (i) company must begin complying on October 1, 2013. A category (iii) company must comply beginning on the first day of the fifth full calendar quarter following the date on which the company became covered.[25]

Exemptions (12 CFR 252.97)

The limits on single counterparty credit exposures in subpart D do not apply to:

- Direct claims on, and the portions of claims that are directly and fully guaranteed as to principal and interest by, the United States and its agencies.

- Direct claims on and the portions of claims that are directly and fully guaranteed as to principal and interest by, Fannie Mae and Freddie Mac, only while operating under the conservatorship or receivership of the Federal Housing Finance Agency. The FRB may determine that additional obligations issued by a U.S. GSE are exempt.

- Intraday credit exposure to a counterparty.

- Any other transaction that the FRB exempts, based on findings that the exemption is in the public interest and consistent with the purpose of the other exemptions.

[25] The existence of a null set category and the fact that a category (i) company could have far less time to prepare for compliance than a category (iii) company cast some doubt on the intent behind the timing of compliance. A better approach would be to allow every covered company at least four quarters in which to prepare.

Risk Management (Subpart E)

Section 165(h) requires every covered company and every publicly traded bank holding company with assets of $10 billion or more to establish a risk committee. The statute prescribes three elements for this committee: (i) responsibility for enterprise-wide risk management, (ii) inclusion of a number of independent members as the FRB deems appropriate, and (iii) inclusion of at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms.[26] The Proposal imposes certain obligations on the committee and requires the appointment of a chief risk officer.[27] The timing of compliance with the risk management requirements is governed by the general first-day-of-the-fifth-quarter principle.

Risk committee (12 CFR 252.126(a)-(c))

A company must adhere to several requirements in setting up a risk committee. The committee must be enterprise-wide, with a formal, written charter approved by the full board. The committee's membership is restricted to directors. Two requirements do not apply to bank holding companies below the $50 billion threshold. The committee must report directly to the full board and may not be housed in another board committee or be part of a joint committee.

An independent director must chair the committee. For public companies, independence is governed by the SEC's Regulation S-K. That is, the company must indicate in its securities filings that the director satisfies the applicable independence requirements of the exchange on which the company's securities are traded. These requirements typically include limitations on compensation paid to the director or his or her family members and prohibitions on material business relationships between the director and the company. A director who is or recently was employed by the company or whose immediate family member is or recently was an executive officer of the company is not independent. For companies that are not publicly traded, the company must demonstrate to the FRB that the director would satisfy the public company requirements if the company were public.

The Proposal requires that at least one member of the committee must have risk management expertise commensurate with the company's systemic footprint. The FRB's expectations are considerably greater, however, and could shrink the pool of qualifying members. All members of the committee generally should have an understanding of the risk management principles and practices relevant to the company. Moreover, the members should have experience developing and applying risk management practices and procedures, measuring and identifying risks, and monitoring and testing risk controls—all specifically with respect to banking organizations (or, if applicable, nonbank financial companies). The level of necessary experience increases with the systemic footprint of the company.

The risk committee has responsibility for management of the company's risk on an enterprise-wide basis. The Proposal identifies specific committee tasks that should be reflected in committee records. As the systemic footprint of a company grows, the risk management framework overseen by the committee should become increasingly robust.

[26] Section 165(h) authorizes the FRB to push the risk committee requirement down to publicly traded bank holding companies with less than $10 billion in assets, but the Proposal does not do so.
[27] The publicly traded bank holding companies with assets between $10 billion and $50 billion, which are subject to the statutory and related regulatory requirements regarding a risk committee are not required to appoint a chief risk officer.

- The committee must document the enterprise-wide policies and procedures of the company—and oversee them.

- The committee must review and approve an appropriate risk management framework, commensurate with the company's systemic footprint. This framework must include:

  - risk limitations for each business line;

  - appropriate policies and procedures relating to risk management governance, risk management practices, and risk control infrastructure;

  - processes and systems for identifying and reporting risks, including emerging risks;

  - monitoring compliance with the company's risk limit structure and policies and procedures relating to risk management governance, practices, and risk controls;

  - effective and timely implementation of corrective actions;

  - specification of management's authority and independence to carry out risk management responsibilities; and

  - integration of risk management and control objectives in management goals and the company's compensation structure.

- Review regular reports from the CRO.

Chief risk officer (12 CFR 252.126(d))

Every covered company must designate a chief risk officer (the "CRO") whose basic responsibility is to implement and maintain appropriate enterprise-wide risk management practices. The CRO must have direct oversight for:

- allocating delegated risk limits and monitoring compliance with such limits;

- establishing appropriate policies and procedures relating to risk management governance, practices, and risk controls;

- developing appropriate processes and systems for identifying and reporting risks, including emerging risks;

- managing risk exposures and risk controls;

- monitoring and testing risk controls;

- reporting risk management issues and emerging risks;

- ensuring that risk management issues are effectively resolved in a timely manner; and

- make regular reports to the risk committee.

The CRO must have a level of expertise commensurate with the systemic footprint of the company, an experience level not much different from that of at least one member of the risk committee. The FRB takes a rigorous position on the necessary degree of experience: an executive whose qualifications and experience are highly focused in a specific area, such as credit risk, would be unlikely to have the required level of expertise to serve as CRO for a company engaged in more diverse businesses.

The CRO must report directly to both the risk committee and the CEO of the company. The compensation structure of the CRO must enable the CRO to provide an objective assessment of the risks taken by the company.

Stress Tests (Subparts F and G)

Section 165(i) of the Act requires two sets of stress tests, one by the FRB and the other by the covered company. In addition to covered companies, all publicly traded bank holding companies with assets in excess of $10 billion must conduct annual stress tests.[28]

The tests could have interesting and not entirely foreseen consequences. Both tests likely would have the same inputs—the same assumptions, since the FRB provides all of them, and presumably identical data. The FRB would have the authority to request the same data that the covered company uses. The methodologies will be somewhat different, however. The FRB's stress tests will be standardized across all covered companies, while company tests will necessarily be tailored to each company. Differences in test results, particularly where results may seem skewed, will result in heightened scrutiny by the FRB.

Different test results might have other important consequences. The company-specific results of both the FRB and the covered company tests must be made public in mid-April of each year.[29] Despite differences in methodologies (or perhaps because of them), any differences could be important to investors, counterparties, and other regulators as an apparent reflection on management and its ability to handle risk in distress conditions. Adverse conclusions could affect access to the capital markets. Further, the results of the annual tests for all companies will become public at approximately the same time, initiating a variety of cross-company comparisons by a range of third parties. Finally, because the FRB may require changes to a company's resolution plan that will be based at least in part on the published stress test results, a company may be compelled to make parts of the resolution plan public that the resolution plan regulation does not require be made public.

The year in which a covered company must begin submitting information to the FRB and conducting its own stress tests is complicated. September 30 is the critical date because it is financial data as of that date that are the quantitative inputs to the stress tests. Companies that are covered as of the effective date must begin compliance that year; the first duties begin each year shortly after September 30. There is no transition period; if the effective date is shortly before September 30, a covered company still must begin compliance then. A bank holding company that passes the $50 billion floor after the rule takes effect must begin compliance as of the September 30 that is at least 90 days after the time at which it passes the floor. If this transition occurs as of the end of the second calendar quarter (June 30), compliance would be necessary in the same year. Nonbank financial companies that are deemed systemically important by the FSOC after the effective date of the rule must begin their compliance as of the first September 30 that is at least 180 days after the designation.

FRB tests (12 CFR 252.133 - .136)

The FRB must conduct annual stress tests of covered companies under section 165(i)(1) of Dodd-Frank. The statutory purpose of the tests is to evaluate whether covered companies have the capital necessary to absorb losses as a result of adverse conditions. Accordingly, the tests must assess capital adequacy under baseline, adverse, and severely adverse conditions. The tests build on the Supervisory Capital Assessment Program from 2009 and the Comprehensive Capital Analysis and Review in late 2010. The FRB tests outlined in the Proposal are designed to work in tandem with the capital plan rule.

[28] Section 165(i) does not require the FRB to conduct its own stress tests of these bank holding companies, referred to hereafter as the "$10 billion companies." The FRB has discretion to do so but has not included any such provision in the Proposal.
[29] Section 165(i) does not require that the FRB release summary information on a company-specific basis.

The FRB has developed an annual cycle for its stress tests, and it may be most helpful to review the duties of covered companies and the testing by the FRB in chronological order.

- After September 30, each covered company will begin compiling data for several quarter-end reports. This process will include gathering information necessary for the FRB's tests. The specifics on the necessary data beyond that provided for existing reports are unknown and will be the subject of a future rulemaking on information collection. The FRB may require virtually any data from a covered company.

  It seems clear that the FRB will ask for data regarding on- and off-balance sheet exposures, including exposures in the company's trading portfolio, other trading-related exposures (i.e., counterparty credit risk exposures), and positions in the trading portfolio that are sensitive to changes in market prices and interest rates.[30] The FRB also will request information that would enable it to estimate the sensitivity of the company's revenues and expenses to changes in economic and financial conditions.

- In mid-November of each year, covered companies must submit to the FRB regulatory reports and any other necessary stress-test data as of September 30. The FRB may later request supplemental information, presumably on a company-specific basis.[31] Information submitted to the FRB for use in the stress test will be subject to the same level of protection that applies to the submission of other data under the Freedom of Information Act. The Proposal does not, however, specifically protect the data submitted as information provided for examination or supervisory reasons.

- At the same time (the order is not clear), the FRB will provide to the covered companies the conditions for each of the three scenarios that it will use in conducting its stress tests. (The companies will use the same assumptions in their own tests.) This information will include a range of macroeconomic and financial indicators, such as real gross domestic product, the unemployment rate, and equity and property prices. To address trading positions that may have large short-term volatility with respect to adverse market events, the FRB also will provide market price and interest "shocks" that are consistent with historical or other adverse market events. The level or quality of the assumptions will apply to the three scenarios in the following ways, as described by the FRB:

  - *Baseline*. The FRB will consider the most recently available views of the macroeconomic outlook expressed by government agencies, other public-sector organizations, and private-sector forecasters as of the beginning of the annual stress-test cycle. Note that if these views are positive, the results of this scenario might show increased capital without any action on the part of a covered company. Of course, a positive outlook likely would lead to greater growth or expansion, in which case additional capital also would be necessary.

  - *Adverse*. This scenario could include economic and financial conditions consistent with a recession of at least moderate intensity, including a shortfall of

[30] Note that all of the banking organizations to be tested by the FRB will soon be subject to prohibitions and restrictions on proprietary trading. Among other things, the recent Volcker Rule proposal suggests that assets in the trading book with high volatility—i.e., high sensitivity—are likely to reflect prohibited trading.
[31] In its discussion of the Proposal, the FRB suggests that submissions of data as of calendar quarter ends in addition to September 30 may be required, but the proposed regulation does not include such a provision.

economic activity and increase in unemployment relative to the baseline scenario, weakness in household incomes, declines in asset prices (including equities, corporate bonds, and property prices) and changes in short- and long-term yields on government bonds.

- *Severely adverse*. The assumptions here would consist of economic and financial conditions that are more unfavorable than those of the adverse scenario and that also include, in some instances, salient factors that are likely to place notable strains on at least some lines of business. For example, these conditions could include precipitous declines in property or other asset prices; shifts in the shape of the yield curve; marked changes in the propensity of households or firms to enter bankruptcy; or strains on households, businesses, or real property markets in particular regions of the United States.

- By January 5, the companies will have submitted to the FRB both the results of its own stress tests and their capital plans.

- By early March, the FRB will have completed its stress tests and will communicate the results to the covered companies. As part of these tests, the FRB will calculate pro forma, post-stress capital levels and ratios over at least nine calendar quarters under the three scenarios. The tests also will produce projections of losses, pre-provision net revenue, and allowance for loan losses. The FRB plans to publish the conditions included in each of the scenarios in advance of the annual tests and will publish an overview of its methodologies.

  The FRB expects that some (and possibly all) covered companies will need to take one or more actions after taking the results of the FRB tests into account. Such actions would include appropriate changes to the company's (i) capital structure, (ii) exposures, concentrations, and risk positions, (iii) recovery plans, and (iv) risk management.

- By March 31, the FRB will provide comments to the covered companies on their capital plans, using the results of its own stress tests, as well as reviews of the companies' own tests. (The companies will evaluate these comments and make any appropriate amendments to their plans within 30 calendar days.)

- In mid-April, the FRB will publish the summary results of the stress tests. These summaries will be company-specific and will have some detail, notwithstanding the FRB's characterization of the summaries as "high level" and its cautionary statements about the use of these summaries by the public. For each tested company, the FRB proposes to publish estimated losses, including overall losses on loans by subportfolio, available-for-sale and held-to-maturity securities trading portfolios, and counterparty exposures; estimated pre-provision net revenue; estimated allowance for loan losses; and estimated pro forma regulatory and other capital ratios. These results will be published for each quarter-end within the FRB's planning horizon in the tests, presumably at least nine quarters. In its discussion, the FRB recognizes that its published results may differ from the published results of a covered company's own stress tests but offers no mechanism for explaining the differences to the public.

  The FRB may require changes to resolution plans based on test results; any such changes must be made within 90 days of the FRB's publication of its stress test results. In the worst case, the FRB's tests could trigger early remediation.

Company tests (12 CFR 252.141 - .148)

Section 165(i)(2) requires all covered companies to conduct internal stress tests semi-annually and, in addition, all financial companies with total consolidated assets of more than $10 billion and that are regulated by a federal banking agency, the Securities and Exchange Commission or the Commodity Futures Trading Commission to conduct annual stress tests. Given the FRB's jurisdiction with respect to the non-covered companies, the Proposal covers only bank holding companies and state member banks that are over the $10 billion threshold.[32] Other financial companies with more than $10 billion in assets and that are regulated by federal agencies other than the FRB must await direction from those agencies, although the requirements of those agencies should not differ materially from those of the FRB.[33] With respect to all of these organizations, multiple stress tests may be required, one for the top-tier holding company and one for each insured depository institution or other financial company with consolidated assets of more than $10 billion. These additional tests will be submitted to the primary federal regulator. The FRB will coordinate with the other agencies in providing scenarios and for other purposes.

The company tests are intended to produce quantitative estimates of essentially the same items as the FRB tests: (i) *pro forma* capital levels and capital ratios, including regulatory ratios or other ratios specified by the FRB; (ii) losses by exposure category; (iii) pre-provision net revenue; (iv) allowance for loan losses; (v) total assets and risk-weighted assets, (vi) aggregate loan balances; and (vii) potential capital distributions over the planning horizon. The planning horizon is a minimum of nine calendar quarters. The tests will analyze capital adequacy under the same three scenarios used for the FRB tests: baseline, adverse, and severely adverse. The conditions within each scenario will be the same in both the FRB and the company tests and will be provided to each company for the annual test. For the second, semi-annual test, a covered company will develop its own conditions for each scenario. The annual test uses company data as of September 30;[34] the second test required for covered companies will be as of March 31.

As with the FRB tests, the Proposal contains an annual cycle for the company tests, which is intended to dovetail with the FRB cycle. Soon after September 30, each company should begin compiling the data necessary for FRB's and its own stress tests. In mid-November, the FRB will provide the conditions for each scenario, and at that point, the companies can begin their tests. They will have slightly over a month to do so. They must submit reports of the tests to the FRB by January 5 of each year, together with the annual capital plans.

Covered companies conducting a second test must file a second report by July 5. The FRB will not provide scenarios for these second tests; each company must develop its own set of conditions for each of the baseline, adverse, and severely adverse scenarios.

The content of the report to be filed by January 5 will be set forth in detail in a separate rulemaking. In addition to the quantitative outputs enumerated above, qualitative items also will be required, including (i) a general description of the company's use of the stress test, (ii) a description of the risks captured in the test, (iii) a general description of the methodologies

[32] Savings and loan holding companies are subject to the same requirements, but the effective date (and therefore compliance obligations) has been delayed only after the FRB has established consolidated capital adequacy guidelines for these institutions.

[33] The FDIC recently issued a "substantively similar" testing proposal for state nonmember banks with more than $10 billion in consolidated assets. The proposal is available at http://www.fdic.gov/news/board/2012/2012-01-17_notice_no4.pdf.

[34] There will be a different as-of date for trading and counterparty exposures. The FRB will determine that date and provide it to each testing company.

used to estimate the numerical results, (iv) assumptions about capital distributions, and (v) for covered companies, a description of the variable used for the three scenarios. The annual report may cross-reference information submitted with the capital plan. Indeed, because stress-test results will be submitted at the same time as capital plans, stress-testing and capital planning should be part of a continuous planning and testing function that also encompasses resolution planning. Based on the information provided in the stress test results, the FRB will analyze the quality of each company's testing processes and results.

Within 90 days after submission of the required report, a covered company or an over-$10 billion banking organization must publish on its website or other reasonably accessible public place a summary of the stress-test results. Covered companies also must publish a summary within 90 days after submission of the second report in early July.[35] This summary must have four substantive elements.

- A description of the types of risks being included in the stress test.

- For each covered company, a high-level description of scenarios developed for the second test, including key variables used (such as GDP, unemployment rate, and housing prices).

- A general description of the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon.

- 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 FRB) over the planning horizon under each scenario.

It must describe the types of risks included in the stress test and the methodologies employed to estimate losses, revenues, allowance for loan losses, and changes in capital positions over the planning horizon. The summary also must present largely the same types of financial results that the FRB must include in its publication of results. Covered companies also must explain how they developed the scenarios for the second test, including the key variables they used.

A company's stress tests will not pass or fail any particular metric. The FRB will review the test results as part of its supervision of each company and will provide feedback through the supervisory process.

The Proposal calls for certain controls over the stress testing process. There are two specific requirements:

- A covered company must establish policies and procedures that 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 policies and procedures also must include information describing its processes for scenario development for the additional stress tests.

[35] In other words, the second set of test results are likely to be published in early October, just as a company is gearing up for the annual report. Public or supervisory reaction may inform the annual test.

- The board of directors and senior management must, on an annual basis, approve and review the controls, oversight, and documentation (including policies and procedures) of the company.

Debt-to-Equity Ratio Limit (Subpart H)

Section 165(j) directs the FRB to limit a covered company's debt-to-equity ratio to no more than (and conceivably less than) 15-to-1, if the FSOC has made two findings: (i) that the company poses a "grave threat" to U.S. financial stability and (ii) that the imposition of the requirement is necessary to mitigate the risk that the company poses to financial stability.[36] "Grave," which is undefined in Dodd-Frank, may be superfluous since section 165(j) does not instructs the FSOC to consider the same factors it uses when determining whether a U.S. or foreign nonbank financial company should be supervised by the FRB. The touchstone for such a determination is a "threat" to U.S. financial stability.

The Proposal does little more than define the debt-to-equity ratio and to establish a time frame for imposing and lifting the ceiling. Debt consists of total liabilities. Equity means total equity capital less goodwill. This information will be as reported by a bank holding company on the FR Y-9C or by a nonbank financial company in the new report of financial condition that it will be required to file with the FRB.

A covered company will receive written notice of the FSOC's determination that it must conform to the debt-to-equity limit. The company has 180 days in which to comply. Two extensions of 90 days each are available, if the Board determines that the company has made good faith efforts to comply and that an extension would be in the public interest. The cap will be removed as soon as the FSOC determines that no grave threat exists.

The debt-to-equity ceiling functions largely as an incentive to maintain or increase the capital of a covered company. If a company fails to do so and the ceiling is put in place, the FRB expects the company to increase equity capital through limits on distributions, share offerings, and other capital raising efforts. The FRB would look more skeptically at efforts to improve the ratio through asset sales or presumably other actions that would shrink the company.

[36] "Grave threat" is not defined, and the debt-to-equity ratio is the only provision in the Act triggered by the finding of a grave threat.

Early Remediation (Subpart I)

Section 166 requires the FRB (after consultation with the FSOC and FDIC) to prescribe regulations for the early remediation of financial distress at a covered company. The regulations are to be designed to minimize the possibility of insolvency and the consequent effects on U.S. financial stability. The section directs the FRB to define regulatory capital, liquidity, and other forward-looking measurements of financial condition that would trigger early remediation. Remediation is to increase in stringency as the financial condition of a company declines. Less rigorous requirements are to include limits on capital distributions, acquisitions, and asset growth. For companies in later stages of decline, remedies are to include preparation of a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales.[37]

Within the context of enhanced prudential standards, the early remediation procedures represent the FRB's response to many forms of non-compliance with the standards set forth elsewhere in the Proposal. Compliance problems in the areas of capital, liquidity, risk management, or stress-testing will lead to some kind of early remediation. (Violations of the single counterparty exposure rules will not, however.) The range of possible actions is wide. Most are discretionary, but a few actions are required when a particular trigger is pulled.

For bank holding companies, section 166 and the Proposal formalize much of the FRB's supervisory approach to large and complex banking organizations. The mechanics of compliance are new, but much of the substance is not. For nonbank covered companies, however, the requirements are new, and the authority to enforce them is new to the FRB. The early remediation provisions in the Proposal will take effect immediately upon finalization of the regulation; there is no conformance period.

The Proposal creates four levels for regulatory response to a distressed covered company: "heightened supervisory review," "initial remediation," "recovery," and "resolution assessment," which are discussed immediately below. The level appropriate for a distressed covered company is determined by several different triggering events, which are described thereafter.

Remedial actions (12 CFR 252.162)

The four levels of remedial actions are intended to produce a calibrated response to the particular circumstances surrounding a distressed covered company.

- Level 1—heightened supervisory review. By itself, Level 1 is a modest response and serves largely as a gateway to greater responses. Heightened review will occur when a covered company first shows signs of financial distress or material risk management weaknesses such that further decline is probable. Upon the discovery of these signs, the FRB will have 30 days in which to consider and to report on whether the company should be subject to a Level 2 response. Further supervision thus will take one of two courses. First, the FRB may begin to apply Level 2 responses (meaning that Level 1 served simply as a justification for Level 2). Second, the company technically would leave Level 1 because the FRB had taken its Level 1 action—producing a report within 30 days—and determined not to bring

[37] The remediation framework is roughly modeled on the prompt corrective action regime for insured depository institutions that was put in place 20 years ago, *see* 12 U.S.C. § 1831o. This regime, which is based almost exclusively on regulatory capital levels, remains in place at the bank level but has been perceived as inadequate during the financial crisis. The early remediation framework has been deliberately designed to look beyond regulatory capital levels for leading signs of distress that warrant intervention.

Level 2 into play. As a practical matter, however, if a company is not subjected to Level 2 intervention, the FRB will continue to monitor the condition of the company more closely than if it had not triggered Level 1 responses to begin with. Of course, the FRB would be free to take supervisory action as it deems appropriate regardless of how the Proposal might cover a company just at Level 1.

- Level 2—initial remediation. The company may not make capital distributions in a calendar quarter that would exceed 50 percent of its average net income over the two preceding calendar quarters. The company also is subject to several growth restrictions that generally preclude the company from growing at more than 5 percent annually. Both the capital distribution and growth limits are mandatory and effective immediately. Any acquisitions by a company in Level 2 require the prior approval of the FRB. The FRB also must take enforcement action, at a minimum in the form of a memorandum of understanding on the specific steps necessary to improve the company's condition. The FRB has additional authority to restrict the company's business as it sees fit.

- Level 3—recovery. Capital distributions, growth, investments in another company (whether controlling or not), and salary increases or bonuses for senior executive officers or directors are prohibited. Affiliate transactions may be restricted. Changes in management or the board may be required. The company also must enter into a written agreement or other formal enforcement action that requires specific actions to improve capital adequacy. If the company does not comply with the agreement—e.g., it cannot raise sufficient capital—then the FRB may require divestitures of assets identified by the FRB as contributing to the company's decline or that pose substantial risk of contributing to the company's further decline.

- Level 4—resolution assessment. The FRB considers whether the covered company poses a risk to the stability of the U.S. financial system. If the FRB determines that the company should be placed in receivership under the orderly liquidation authority, then it must make the necessary recommendation that begins that process. Unlike the other three levels of early remediation, however, Level 4 remediation is a function exclusively of a covered company's low regulatory capital levels.

Triggers (12 CFR 252.163)

Six separate sets of triggering events—capital and leverage, the results of stress tests, risk management, liquidity, and market indicators—dictate the level of response appropriate for a covered company that seems to be distressed. Five of the six relate to compliance with enhanced prudential standards elsewhere in the Proposal. Each of the triggers involves qualitative judgments by the FRB. If these factors would lead to different levels, the SIFI will be subject to the most stringent response available. Note, however, that resolution assessment must occur when a covered company falls below certain capital levels, regardless of what other triggers might indicate.

- *Capital and leverage*. This trigger is premised on a determination by the FRB that a covered company's capital structure, capital planning processes, or the amount of capital it holds is not commensurate with the level and nature of the risks to which it is exposed. This qualitative judgment may be made even with respect to a well-capitalized company, and accordingly such a company could be subjected to Level 1 treatment. Otherwise, the specific capital ratios in the table below indicate the level of response.[38]

	Total risk-based capital	Tier 1 risk-based capital	Tier 1 leverage
Level 1	10% or more	6% or more	5% or more
Level 2	Between 8 and 10%	Between 4 and 6%	Between 4 and 5%
Level 3	Below 10% for two complete consecutive quarters or between 6 and 8%	Below 6% for two complete consecutive quarters or between 3 and 4%	Below 5% for two complete consecutive quarters or between 3 and 4%
Level 4	Less than 6%	Less than 3%	Less than 3%

An important consideration reflected in the table is that a Level 2 company that cannot restore its capital within only two quarters becomes a Level 3 institution. The FRB also observes that it will modify this framework to take account of any changes to regulatory capital requirements as the result of further Basel II or III developments.

Capital will be deemed to have been calculated as of the most recent of either (i) the FR Y-9C report, (ii) any capital calculations submitted to the FRB at the FRB's request, or (iii) a final inspection report delivered to the company by the FRB that shows capital ratios calculated more recently than in the most recent FR Y-9C.

- *Stress tests*. A company will be subject to a Level 1 response if it has not complied with the capital plan or stress-test regulations—even if it continues to meet minimum regulatory capital requirements in the severely adverse scenario. If the results of a test under the severely adverse scenario for any quarter of the planning horizon reflect a Tier 1 common risk-based capital ratio of less than five percent but more than three percent, then a Level 2 response is indicated. If this ratio is less than 3 percent, then Level 3 is called for. A stress test is deemed to have produced the Tier 1 common ratio as of the date the FRB transmits its stress test report to the company.

- *Risk management*. In general, for a covered company that fails to comply with the enhanced risk management provisions in Subpart E, a Level 2, 3, or 4 response is necessary. If a company has "manifested signs of weakness" in the enhanced risk management and risk committee requirements, then it is subject to a Level 1 response. Level 2 comes into play if the company has demonstrated "multiple deficiencies" in complying with these requirements. "Substantial noncompliance" warrants a Level 3 intervention. The Proposal does not identify any concrete factors to differentiate these judgments.

- *Liquidity*. The triggers here are similar to the risk management triggers. If a company's measurement or management of liquidity risks does not comply with Subpart C, remediation in Level 1, 2, or 3 is appropriate. Signs of weakness in meeting liquidity risk management standards would lead to a Level 1 intervention. Level 2 applies where there are multiple deficiencies and Level 3 where there is substantial noncompliance. The FRB considered but did not proposed quantitative liquidity triggers on the view that such measurements could exacerbate funding pressures at a distressed company.

[38] Capital levels are deemed to have been calculated as of the most recent of the FR Y-9C report, calculations submitted in response to an FRB request, or a final inspection report with capital ratios.

- *Market indicators*. Recognizing that market-based data can provide early signals of financial deterioration, the FRB proposes the use of publicly available market information essentially as a warning sign that the agency should supervise a covered company more carefully. The indicators thus would trigger only a Level 1 response; they would not have a role in the FRB's decision as to whether higher levels of response are called for.

  In the regulatory language in the Proposal, a company will be subject to a heightened supervision if, over a given number of days, its own "market indicator" exceeds a "market indicator threshold." The proposed regulation does not describe the specific indicators; the FRB will develop a list annually, through notice-and-comment rulemaking.

  However, in its discussion of the Proposal, the FRB requests comment on four equity-based indicators—expected default frequency, marginal expected shortfall, market equity ratio, and option-implied volatility—and two debt-based indicators—credit default swaps and subordinated debt spreads. None of these indicators is easily measured. They are based on historical and peer activity, and the indicator or trigger is a point at which a company's own performance is outside the range of common industry performance.

Conclusion

The requirements in the Proposal are not revolutionary and overall are consistent both with sections 165 and 166 of the Act and with the FRB's efforts to supervise large and complex bank holding companies both before and during the financial crisis. Further, the publication of the Proposal may help put to rest some uncertainties as to how the FRB would attempt to apply these core system regulations provisions of Dodd-Frank. In implementing these two sections of the Act, however, the FRB has opted for a detailed set of rules, rather than a set of general principles. As a result, every covered company will have to review its risk management structure and its compliance regime to ensure that it will meet the many specific and detailed requirements. We believe covered companies should focus on the following sets of duties that may present especially complex obligations:

- *Liquidity management*. Even though every covered company already manages liquidity intensively, the Proposal requires a specific management structure and specific sets of decisions and analyses that may not match up with current practices.

- *Liquidity buffer and the underlying liquidity stress test*. The buffer requirement anticipates the Basel III liquidity coverage ratio, even though this ratio still is under discussion in the Basel III process.

- *Credit enhancements for single-counterparty exposures*. The Proposal's use of credit risk mitigants in dealing with this aspect of credit risk is not identical to the use of credit enhancements under the risk-based capital rules and will require a company to review its enhancement techniques.

- *Double stress-testing*. In effect, the FRB will re-test each covered company's internal stress tests, and the results of both will be made public. In order to minimize differences and the adverse consequences that could occur, each company should be prepared to work closely with the FRB on testing issues.

- *Early remediation*. The new regulatory structure for increasing regulatory intervention as a covered company becomes increasingly troubled will require careful monitoring of all compliance efforts (and not just of capital levels).

- *Capital planning by nonbank covered companies*. Specific minimum capital requirements will apply, and each company must prepare the same kind of capital plan as a bank holding company covered by the Proposal. The critical threshold question is whether a nonbank covered company can accommodate the new requirements. The capital planning process will be a substantially new event for companies unaccustomed to dealing with the FRB.

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