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Potential SIFIs Take Note – Your Future Is Being Decided Now: FRB Prepares to Act on Enhanced Prudential Standards

Much attention has been focused on the Financial Stability Oversight Council ("FSOC") as it moves to issue final rules concerning the process by which it will designate nonbank financial companies as systemically important financial institutions ("SIFIs") that will be subject to supervision by the Board of Governors of the Federal Reserve System ("FRB"). Both SIFIs and bank holding companies ("BHCs") with assets of $50 billion or more (together "Covered Companies") will be subject to enhanced prudential standards and early remediation requirements ("Enhanced Standards") that will be implemented by the FRB. The FRB has issued a proposed rule regarding the Enhanced Standards ("Proposal") which is open for comment until March 31, 2012.

The FSOC has not yet issued final rules regarding the designation of SIFIs. See *DechertOnPoint* FSOC Issues New Proposed SIFI Designation Rule. Even when final rules are issued, it is likely to be many months before the first designation of a SIFI is finalized. However, the FRB is acting now on the Enhanced Standards that would apply to a company that may in the future be designated as a SIFI. The Enhanced Standards are likely to have a significant impact on a company designated as a SIFI.

The Enhanced Standards requirements, contained in sections 165 and 166 of the Dodd-Frank Act, are highly bank-centric. Thus, nonbank financial company perspectives on how such standards would need to be tailored to address the differences in operations, activities and structure between nonbank financial companies and large BHCs are critical.

The FRB acknowledges that the Proposal was developed with large, complex BHCs in mind but that some of the standards are sufficiently flexible to be implemented by SIFIs. The FRB indicates that in the case of a company designated as a SIFI, the FRB would assess the business model, capital structure, and risk profile of the SIFI to determine how the Enhanced Standards should apply. The FRB states that it may, by order or regulation, tailor the application of the Enhanced Standards to SIFIs, on an individual basis or by category, as appropriate.

As a general matter, a company that is a Covered Company on the effective date of the final rule will be required to comply with the Enhanced Standards on the first day of the fifth quarter following the effective date. A company that becomes a Covered Company after the effective date of the final rule generally will be required to comply with the Enhanced Standards on the first day of the fifth quarter following the date it became a Covered Company.

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The Proposal addresses the following seven major areas of regulatory oversight.

Single Counterparty Credit Exposure

Perhaps the most complex and significant requirement is that Covered Companies will be subject to credit limits similar to the "loan to one borrower rules" applicable to insured depository institutions. In general, the aggregate net credit exposure of a Covered Company to an unaffiliated counterparty may not exceed 25% of the Covered Company's capital and surplus. A more stringent 10% limit applies if both parties are either a very large BHC (total consolidated assets greater than $500 billion) or a SIFI.

- The rules for identifying a group of affiliated companies that must be aggregated either as creditors or debtors and for netting credit exposure are complex and will entail a substantial compliance burden.
- The concept of "net credit exposure" is very broadly defined and includes equity investments in a counterparty.
- The Proposal generally excludes sponsored or advised funds from the calculation of a Covered Company's credit exposure, but requests comment as to whether such funds should be aggregated with a Covered Company that acts as their sponsor or adviser them because of the support many such funds received from their sponsors or advisors during the financial crisis. See *DechertOnPoint* Federal Reserve Board's Enhanced Supervision Standards Could Raise Significant Issues for Money Fund Sponsors.

Risk-Based Capital and Leverage

Under the Proposal, all Covered Companies must comply with the FRB's capital plan rule, which was adopted in November 2011. Covered Companies must demonstrate their ability to maintain capital above existing minimum regulatory capital ratios applicable to BHCs and above a Tier 1 common equity ratio of 5% under three scenarios – baseline, adverse and severely adverse conditions – over a minimum period of nine quarters. Capital plans reflecting all stress test results must be prepared on an annual basis and submitted for FRB review. Covered Companies that fail to submit satisfactory capital plans will be subject to limits on their ability to make capital distributions. The FRB intends to issue a subsequent proposed rule to implement a risk-based capital surcharge for Covered Companies that is consistent with the Basel III recommendations for internationally active banks.

- The forward-looking requirements will introduce considerably more uncertainty and regulatory discretion into the determination of what constitutes appropriate capital.
- SIFIs will become subject for the first time to the asset risk-weighting rules applicable to insured depository institutions and BHCs.

Liquidity

The Proposal introduces comprehensive, quantitative liquidity risk management standards, including internal stress testing at least monthly to measure liquidity needs at 30-day, 90-day and one-year intervals during times of financial instability. Covered Companies also must hold a "liquidity buffer" of unencumbered highly liquid assets sufficient to meet projected net cash outflows over 30 days and must implement certain minimum liquidity risk management procedures. The Proposal emphasizes the role of the board of directors in dealing with liquidity management issues. Separately, the FRB intends to implement the Basel III liquidity standards as they are developed and adopted.

- The criteria for the liquidity buffer may introduce a bias in favor of U.S. and U.S.-backed securities, which may reduce the availability of funding for corporate credit needs.

Risk Management

All Covered Companies and all publicly traded BHCs with $10 billion or more of total consolidated assets must establish a risk committee of the board of directors to oversee enterprise-wide risk management. The risk committee must have a charter, an independent chairman and at least one member with risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities and size. A Covered Company also must employ a chief risk officer who reports directly to both the risk committee and the CEO of the company and has the appropriate independence, expertise and stature to implement robust enterprise-wide risk management practices.

- The detailed oversight of risk management by the risk committee increases the value of directors having extensive technical expertise regarding the financial services markets in which their companies operate.

Stress Tests

The Proposal requires the FRB, in coordination with the appropriate primary federal regulatory agencies and the Federal Insurance Office, to conduct annual stress tests of all Covered Companies ("supervisory stress tests") to determine whether such companies have sufficient capital to absorb losses under baseline, adverse and severely adverse scenarios over a minimum period of nine quarters. Covered Companies also must conduct their own annual stress tests using the same scenarios, and each BHC, savings and loan holding company and state member bank with more than $10 billion in total consolidated assets must conduct a second annual stress test employing its own scenarios (together, "company-run stress tests"). The FRB will publish company-specific summaries of the results of its supervisory stress tests, and each company must publish the results of its company-run stress tests.

Covered Companies and other $10 billion companies must take the results of their company-run stress tests into account when evaluating the adequacy of their capital structures and when updating their living wills.

- The public disclosure requirements for the results of company-run stress tests may present a challenge with respect to the protection of sensitive corporate information.

Debt-to-Equity Limits

If the FSOC determines that a Covered Company poses a "grave threat" to U.S. financial stability and that it is necessary to reduce the company's use of leverage in order to mitigate such risk, the FRB is required to impose a debt-to-equity limit of not more than 15-to-1 on the company. The company must comply within 180 days, although the FRB may extend the compliance period if it finds that to be in the public interest.

- The FSOC must consider the statutory factors in Section 113 of the Dodd-Frank Act for designating a SIFI when identifying a Covered Company as a grave threat, but it has not proposed regulations to establish procedures and timelines for making this identification or determining that a company no longer poses a grave threat.

Early Remediation

Section 166 of the Dodd-Frank Act directs the FRB to adopt regulations for the early remediation of financial weaknesses at Covered Companies. The Proposal sets forth a four-level remediation regime, based on several forward-looking triggers. The remedial actions increase in stringency at each level as the financial condition of a Covered Company deteriorates:

- Level 1 (Heightened Supervisory Review) – A Covered Company that is well capitalized but exhibits signs of weakness in capital structure, capital planning, stress test results, enhanced risk management or enhanced liquidity management or through specific market indicators is subject to a targeted review to determine if it should be moved to the next level of review.

- Level 2 (Initial Remediation) – A Covered Company that is adequately capitalized but exhibits signs of moderate weakness in stress test results, enhanced risk management or enhanced liquidity management is subject to restrictions on capital distributions and growth.

- Level 3 (Recovery) – A Covered Company that shows signs of severe weakness must enter into an enforceable written agreement with the FRB that prohibits all capital distributions (including discretionary bonuses and pay increases), all growth in asset size and all material acquisitions, requires the Covered Company to raise additional capital and may require additional actions, such as the removal of senior management, on a case-by-case basis.

- Level 4 (Recommended Resolution) – If a Covered Company's regulatory capital falls below designated levels, the FRB must consider whether to recommend to the Treasury and the FDIC that the company be resolved under the orderly liquidation authority of Title II of the Dodd-Frank Act.

Conclusion

Potential SIFI designees should carefully evaluate the impact that the Proposal would have on their operations, activities and financial condition and consider submitting comments that address the issues that such an evaluation raises.

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