Simpson
Thacher

Memorandum

Federal Reserve Proposes Rules to Tailor Enhanced Prudential Standards for U.S. Banking Organizations

November 5, 2018

On October 31, 2018, the Federal Reserve issued a pair of proposed rulemakings—one issued by the Federal Reserve alone and another issued jointly by the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation—that together would tailor the application of certain enhanced prudential standards under Section 165 of the Dodd-Frank Act to U.S. banking organizations based on four categories of risk profiles to which varying prudential standards would apply. The proposed rules follow the increase of the asset size threshold for general application of enhanced prudential standards from $50 billion to $250 billion under the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Reform Act"). Consistent with Congress' mandate under the Reform Act for the Federal Reserve to take into consideration risk-based factors (other than asset size alone) when determining whether to apply enhanced prudential standards to banking organizations with at least $100 billion in assets, the proposed rules would delineate the four categories of standards based on asset size and other factors such as the degree of a firm's cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposures. In particular, the proposal includes the following categories:

- *Category I Firms*: U.S. global systemically important bank holding companies ("GSIBs") would remain subject to the most stringent standards.
- *Category II Firms*: Firms with at least $700 billion in total assets or at least $75 billion in cross-jurisdictional activity would be subject to more stringent prudential standards (excluding GSIB-specific requirements).
- *Category III Firms*: Firms with at least $250 billion in total assets or at least $100 billion in total assets and at least $75 billion of a risk-based indicator (*e.g.*, weighted short-term wholesale funding,

nonbank assets, or off-balance sheet exposure) would be subject to enhanced standards that are tailored to the risk profile of these firms.

- *Category IV Firms*: Firms with $100 billion to $250 billion in total assets that do not otherwise meet the thresholds for one of the other categories would be subject to significantly reduced requirements.

Federal Reserve Governors Powell, Quarles and Clarida each voted in favor of the proposed rules during the Board's October 31 open board meeting. Governor Brainard voted against the proposal, based on her view that the proposed rules "go beyond the statutory provisions" of the Reform Act and "weaken the buffers that are core to the resilience of our system."

Following is a high-level summary of certain key features of the proposed rules.

Background

Since the 2008-2009 financial crisis, the Federal Reserve has applied a number of "enhanced prudential standards" to bank holding companies with $50 billion or more in total assets pursuant to Section 165 of the Dodd-Frank Act. These enhanced prudential standards include capital planning requirements; supervisory and company-run stress testing; risk management and risk committee requirements; single counterparty credit limits; and standardized liquidity requirements, proposed net stable funding rules, and liquidity risk management, stress testing, and buffer requirements.

The Reform Act, signed into law on May 24, 2018, amended Section 165 of the Dodd-Frank Act with respect to the applicability of these enhanced prudential standards, most notably by raising the total asset threshold for general application of enhanced prudential standards from $50 billion to $250 billion. The Reform Act also authorized the Federal Reserve to apply enhanced prudential standards to banking organizations with between $100 and $250 billion in total assets, but only if the Federal Reserve first determines that a particular enhanced prudential standard is appropriate in consideration of various risk-based factors (including capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Federal Reserve deems appropriate).

The proposed rules would implement the Reform Act amendments to Section 165 by differentiating between banking organizations based on certain risk-based factors other than asset size alone.

Four Categories of Standards

A. Category I

Category I standards, which would constitute the most stringent of the enhanced prudential standards, would apply only to U.S. GSIBs, as determined in accordance with the Federal Reserve's current GSIB

surcharge scoring methodology.[1] In general, the proposal would make no changes to the requirements applicable to U.S. GSIBs, except to reduce the frequency of required company-run stress testing from semi-annual to annual.

1. *Capital*

U.S. GSIBs and their subsidiary depository institutions would remain subject to the most stringent capital requirements, including a requirement to calculate risk-based capital ratios using both the advanced approaches and the standardized approach, the GSIB surcharge (at the holding company level only), the U.S. leverage ratio, the enhanced supplementary leverage ratio, a requirement to recognize most elements of accumulated other comprehensive income ("AOCI") in regulatory capital, the countercyclical capital buffer requirement, if applicable, and total loss-absorbing capacity and long-term debt requirements.

2. *Liquidity*

Category I liquidity standards applicable to U.S. GSIBs would continue to include the full liquidity coverage ratio ("LCR") requirement, as well as the proposed net stable funding ration ("NSFR") requirement once finalized. Consistent with current requirements, a subsidiary depository institution of a U.S. GSIB with $10 billion or more in total assets would be required to meet the LCR and NSFR requirements. While this $10 billion asset threshold is currently measured based on the most recent year-end Call Report, the proposal would amend the LCR and proposed NSFR rules to measure this threshold based on the value of total assets over the four most recent calendar quarters.

U.S. GSIBs would also continue to be subject to liquidity risk management, monthly internal liquidity stress testing and liquidity buffer requirements, as well as requirements to report certain liquidity data for each business day (through Form FR 2052a).

3. *CCAR & Stress Testing*

Prior to the enactment of the Reform Act, Section 165 of the Dodd-Frank Act required a bank holding company subject to enhanced prudential standards to conduct semi-annual company-run stress tests. The Reform Act amended this provision to require company-run stress tests on a "periodic" basis for firms subject to enhanced prudential standards. Under the proposed rules, U.S. GSIBs would no longer be required to conduct mid-year company-run stress tests, effective in the 2020 cycle, but would continue to be required to conduct an annual company-run stress test and be subject to an annual supervisory stress test.

In addition, U.S. GSIBs would remain subject to both the qualitative and quantitative components of the annual Comprehensive Capital Analysis and Review ("CCAR") process.

---

[1] The eight banking organizations that have been identified as GSIBs to date are Bank of America, BNY Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo.

B. Category II

Category II standards would apply to U.S. bank holding companies that have (i) at least $700 billion in total assets, or (ii) at least $100 billion in total assets and at least $75 billion in cross-jurisdictional activity (as reported on the firm's Form FR Y-15).

1. *Capital*

Category II capital standards would include standardized and advanced approaches capital requirements, the U.S. leverage ratio, the supplementary leverage ratio, a requirement to recognize most elements of AOCI in regulatory capital, and the countercyclical capital buffer requirement, if applicable. As under existing requirements, the proposed Category II capital standards would apply to the subsidiary depository institutions of holding companies subject to Category II standards.

2. *Liquidity*

Banking organizations subject to Category II standards would continue to be subject to the full LCR and proposed NSFR requirements once finalized. As under existing requirements, the LCR and proposed NSFR requirements would also apply to subsidiary depository institutions with total consolidated assets of $10 billion or more (subject to the revised asset threshold determination method described above).

In addition, Category II standards would continue to apply liquidity risk management, monthly internal liquidity stress testing and liquidity buffer requirements, as well as daily FR 2052a reporting requirements, to subject firms.

3. *CCAR & Stress Testing*

Under the proposed rules, the Federal Reserve would continue to require a firm subject to Category II standards to submit an annual capital plan under CCAR, and would conduct both a qualitative and quantitative assessment of the capital plan.[2] In addition, the proposed rules would maintain annual supervisory stress testing for Category II firms and require company-run stress testing on an annual basis.

C. Category III

Category III standards would apply to firms with total consolidated assets of $250 billion or more that do not meet the criteria for Category I or II, as well as to firms with between $100 billion and $250 billion in total assets that also have at least $75 billion of (i) total nonbank assets (calculated pursuant to Form

[2] In 2017, the Federal Reserve finalized a rule that removed the qualitative assessment component of CCAR for bank holding companies with less than $250 billion in total assets and less than $75 billion in nonbank assets. For Category II firms that were previously exempted from the CCAR qualitative component (*i.e.*, firms with less than $250 billion in total assets and less than $75 billion in nonbank assets, but at least $75 billion in cross-jurisdictional activity), the proposal would increase the stringency of the capital planning standards by once again subjecting these firms to the CCAR qualitative assessment.

FR Y-9LP), (ii) off-balance sheet exposures (calculated pursuant to Form FR Y-15), or (iii) weighted short-term wholesale funding (calculated pursuant to Form FR Y-15).

1. *Capital*

Banking organizations subject to Category III standards would not be required to apply advanced approaches capital requirements and would not be required to recognize most elements of AOCI in regulatory capital. Category III firms would, however, be subject to generally applicable risk-based capital requirements and capital buffers (including any applicable countercyclical capital buffer), as well as the U.S. leverage ratio and the supplementary leverage ratio.

2. *Liquidity*

Under the proposed rules, Category III standards would include full or reduced LCR and NSFR requirements, depending on a banking organization's level of weighted short-term wholesale funding. Specifically, a Category III firm that has weighted short-term wholesale funding of $75 billion or more would be subject to the full LCR and NSFR requirements, while a Category III firm that has less than $75 billion in weighted short-term wholesale funding would be subject to reduced LCR and NSFR requirements. The agencies have proposed applying reduced standards that would be equivalent to between 70% to 85% of the full LCR and NSFR requirements to Category III firms with less than $75 billion in weighted short-term wholesale funding, but are requesting comment regarding the appropriate level of stringency to be applied. The proposal would not otherwise alter the LCR and NSFR calculations for these banking organizations relative to the full LCR and proposed NSFR requirements.

Like the current LCR and NSFR requirements, the proposal would apply Category III LCR and NSFR requirements to depository institution subsidiaries that have total consolidated assets of $10 billion or more. The level of the LCR and NSFR requirements applicable to the depository institution subsidiary would be the same as the level that would apply to the Category III parent banking organization.

The proposal would also maintain the existing liquidity risk management, monthly internal liquidity stress testing, and liquidity buffer requirements for firms subject to Category III standards. Category III firms would be subject to FR 2052a reporting requirements, on a daily or monthly basis depending on the firm's level of weighted short-term wholesale funding.

3. *CCAR & Stress Testing*

The proposal would largely maintain existing CCAR capital planning and stress testing standards for firms subject to Category III standards. For example, Category III firms would continue to be required to submit

an annual CCAR capital plan subject to both the qualitative and quantitative assessments,[3] and would continue to be subject to annual supervisory stress testing by the Federal Reserve.

The proposed rules would reduce the required frequency of company-run stress testing to every other year for Category III firms, but would maintain the annual internal stress test requirement under the CCAR capital plan rule. As a result, in the intervening year between company-run stress tests under the enhanced prudential standards rule, the proposed Category III standards would require a firm to conduct an internal capital stress test as part of its annual capital plan submission, without required public disclosure.

D. Category IV

Category IV standards would apply to banking organizations with total assets of $100 billion or more that do not otherwise meet the thresholds for one of the other categories.

1. *Capital*

Category IV capital standards would include the generally applicable risk-based capital requirements and the U.S. leverage ratio, but would not apply the countercyclical capital buffer or the supplementary leverage ratio. As a result, banking organizations subject to Category IV standards would generally have the same regulatory capital requirements as banking organizations with under $100 billion in total assets. Unlike firms with less than $100 billion in total consolidated assets, however, firms subject to Category IV standards would be required to monitor and report certain risk-based indicators.

2. *Liquidity*

Under the proposed rules, the LCR and proposed NSFR rules would no longer apply to firms subject to Category IV standards. The proposal would also reduce the frequency of required internal liquidity stress testing for Category IV firms to at least quarterly, rather than monthly. Category IV firms would, however, continue to be required to maintain a liquidity buffer sufficient to meet its projected net stressed cash-flow needs over a 30-day planning horizon under the firm's internal liquidity stress test, and to provide FR 2052a reporting.

The proposal would also modify certain liquidity risk management requirements for firms subject to Category IV standards. First, the proposal would require a Category IV firm to calculate its collateral positions on a monthly basis, rather than a weekly basis as currently required. Second, Category IV firms would not be required to establish liquidity risk limits for activities that are not relevant to the firm. Third, the proposal would reduce the number of required elements of monitoring intraday liquidity risk exposures.

---

[3] Similar to the effect for Category II firms, the proposal would increase the stringency of the capital planning standards for certain Category III firms (*i.e.*, those with less than $250 billion in total assets and less than $75 billion in nonbank assets, but at least $75 billion in off-balance sheet exposures or weighted short-term wholesale funding) by re-applying the CCAR qualitative assessment to these firms.

3. CCAR & Stress Testing

The proposed rules would revise the frequency of supervisory stress testing for Category IV firms to every other year, and would eliminate entirely the requirement for Category IV firms to conduct and publicly report the results of a company-run stress test.

The Federal Reserve is proposing to maintain existing FR Y-14 reporting requirements for firms subject to Category IV standards in order to provide the Federal Reserve with the data it needs to conduct supervisory stress testing and inform the Federal Reserve's ongoing supervision of these firms.

E. Savings and Loan Holding Companies

Currently, covered savings and loan holding companies are subject to the Federal Reserve's regulatory capital rule and LCR rule, and would be subject to the proposed NSFR rule based on the same categories, in the same manner as a similarly situated bank holding company. However, unlike bank holding companies of comparable size and risk profile, covered savings and loan holding companies are not otherwise subject to capital planning or supervisory stress testing requirements.

Under the proposal, a covered savings and loan holding company would be subject to supervisory stress testing, a requirement to conduct and publicly disclose the results of a company-run stress test, risk management and risk committee requirements, liquidity risk management, stress testing, buffer requirements, and single-counterparty credit limits in the same manner as a similarly situated bank holding company would be subject under the enhanced prudential standards rule.

To implement the supervisory stress test, the Board is proposing to require covered savings and loan holding companies to report the FR Y-14 report in the same manner as a bank holding company. In addition, the Federal Reserve noted that it expects to seek comment on a future proposal to apply its proposed stress buffer requirements to covered savings and loan holding companies in the same manner as a bank holding company.

Alternative Scoping Criteria

As an alternative approach for assessing the risk profile and systemic footprint of a banking organization for purposes of tailoring prudential standards, the agencies invited comment on the use of a single, comprehensive score calculated pursuant to the GSIB identification scoring methodology to tailor prudential standards for large, but not globally systemic, banking organizations.

Under the alternative scoring approach, a banking organization's size and either its method 1 or method 2 score from the GSIB scoring methodology would be used to determine which category of standards would apply to the firm. In particular:

- *Category I* standards would continue to apply to U.S. GSIBs, which would continue to be defined as U.S. banking organizations with a method 1 score of 130 or more.
- *Category II* standards would apply to any non-GSIB banking organization with at least $100 billion in total assets and with a method 1 score between 60 and 80 or a method 2 score between 100 to 150.
- *Category III* standards would apply to banking organizations with between $100 billion and $250 billion in total assets and with a method 1 score between 25 to 45 or a method 2 score between 50 to 85.
- *Category IV* standards would apply to banking organizations with at least $100 billion in total assets and with a method 1 score of less than 25 or a method 2 score of less than 50.

In each case, if the agencies were to adopt a final rule that uses the GSIB scoring methodology to establish tailoring thresholds, the agencies would set a single score within the listed ranges for application of each respective category of standards.

IMPACT Assessment

The Federal Reserve predicts that the proposal will provide benefits including increased net interest margins, reduced compliance cost, and increased regulatory flexibility. It expects no material impact on the capital levels of firms in Category I or II, and expects that the proposal will slightly lower capital requirements (by approximately 60 basis points of total risk-weighted assets among these banking organizations) and reduce compliance costs for those in Category III or IV. Further, the Federal Reserve anticipates that the new liquidity requirements would reduce aggregate high-quality liquid assets by approximately 2.5% but would raise net interest margin slightly for the firms in Category III and IV.

Looking Ahead

Comments on the proposed rules are requested by January 22, 2019. In addition to the proposed tailoring rules, the Federal Reserve signaled that it is expecting to release three additional future rulemakings:

- *International Bank Proposal*: The proposed rules would not apply to a foreign banking organization, including to an intermediate holding company of a foreign banking organization. The Federal Reserve noted that it continues to consider the appropriate way to assign the U.S. operations of foreign banking organizations to the categories of prudential standards, and that it plans to develop a separate proposal to implement the Reform Act's amendments to Section 165 with respect to foreign banking organizations. As required by the Dodd-Frank Act and longstanding principles, the Federal Reserve indicated that any future proposal for foreign banking organizations would reflect the principles of national treatment and equality of competitive opportunity.

- *Capital Plan Proposal*: The Federal Reserve indicated that it plans to issue a future capital plan proposal which would provide greater flexibility to Category IV firms to develop their annual capital plans, including by eliminating the requirement for these firms to submit the results of company-run stress tests on Form FR Y-14A.
- *Resolution Planning Proposal*: The Federal Reserve noted that it intends to issue a proposal that would address the applicability of resolution planning requirements to firms with total consolidated assets in the range of $100 billion to $250 billion. In connection with that process, the Federal Reserve is working with the FDIC to amend their joint resolution plan rules to, among other things, adjust the scope and applicability of the resolution plan requirements for companies that remain subject to the resolution plan requirement.

For further information, please contact one of the following members of the Firm's Financial Institutions Group.

FINANCIAL INSTITUTIONS GROUP

Lee A. Meyerson
+1-212-455-3675
lmeyerson@stblaw.com

Keith A. Noreika
+1-202-636-5864
keith.noreika@stblaw.com

Adam J. Cohen
+1-202-636-5578
adam.j.cohen@stblaw.com

Spencer A. Sloan
+1-212-455-7821
spencer.sloan@stblaw.com

Julie Siegel
+1-212-455-2126
julie.siegel@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000