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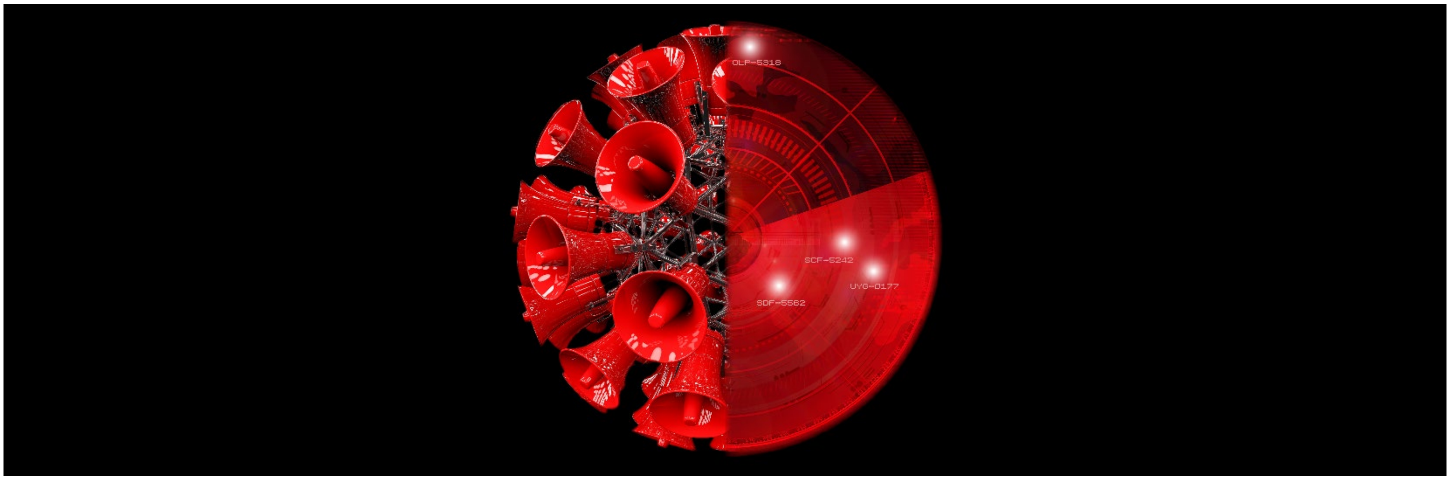

Federal Reserve Board finalized tailoring Prudential Standards for foreign banking organizations

On October 10th, 2019, the Federal Reserve Board (FRB) finalized the tailoring of post-crisis regulatory framework for foreign banking organizations (FBOs) Enhanced Prudential Standards (EPS).[1] According to Chair Jerome H. Powell the rule "...kept the toughest requirements on the largest and most complex firms, because they pose the greatest risks to the financial system and our economy".[2] Governor Lael Brainard was the sole objection to the final rule stating the rule provides "little benefit to the banks or the system from the proposed reduction in core resilience that would justify the increased risk to financial stability in the future…" She also noted that by deferring liquidity requirements for US branches of FBO the rule fails to take into considerations one of the key outstanding risks in the current landscape.[3]

The final rule marks a significant new stage in the evolution of tailoring by bank regulators that has intensified since its early start decades ago. As designed, the EPS tailoring rule fine tunes requirements for capital, stress testing, liquidity, large exposures and reporting based on financial metrics that serve as a proxy for a firm's size, complexity, interconnectedness and systemic importance.

While the Fed used its discretion in establishing the tailoring metrics, the rule is largely consistent with the asset size thresholds laid out in in the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)[4] and in some cases provides tailoring relief beyond that in the legislation; that legislation gave the FRB greater discretion to tailor or eliminate EPS requirements. In a complementary rulemaking, the FRB and Federal Deposit Insurance Corporation (FDIC) also tailored requirements related to resolution plans or "living wills" in a similar manner.[5] Moreover, the banking agencies are working to finalize their related EPS and other rules at the insured depository level.

Efforts to tailor the post-crisis reform standards reflect concern that the initial efforts had gone too far and did not adequately balance the tradeoff between safety and soundness and burden, especially for smaller and less complex firms. Much of the tailoring reflects the experience of the industry and regulators in implementing and enforcing the latest rules and guidance. To date, only very modest relief has been granted to the largest banks, while smaller banks received modest to substantial relief.

The final rule will be effective 60 days from being published in the Federal Register.

Applicability

The final framework applies to all FBOs or any Intermediate holding company ("IHC") of an FBO with more than $100 billion in global consolidated assets. However the IHC requirement still applies with US non-branch assets of $50 billion. Further, other enhance prudential standards may still apply to FBOs depending on the size of US assets (e.g., application of home country stress testing requirements).

Final Rule remains consistent with the proposed framework

The final rule assigns FBOs to one of four categories each with its own set of tailored requirements based on the risk profile of its combined US operations (CUSO) or its IHC, as measured by size and other risk-based measures.[6] Organizations that fall within the four categories would be subjected to the applicable capital, liquidity and prudential standards, based on their size and risk profile.

The final tailoring rule remains largely aligned to the proposed tailoring rule issued in April 2019, with few exceptions:

1. Reduced standardized liquidity requirement:

The proposed rule solicitated comments on how Liquidity Coverage Ratio ("LCR") should be calibrated and proposed a range between 70 and 85 percent of the full LCR requirement for category III and IV FBOs driven by the weighted Short-term Wholesale Funding (wSTWF) factor, while the final rule adopts specific thresholds for the same.

	Category III (<\$75b in wSWTF)	**Category IV (\$50b to <\$75b in wSWTF)**
Reduced Standardized Liquidity Requirements	85% of full LCR Requirement	70% of full LCR Requirement
	100% of the full LCR Requirement (≥ \$75b in wSWTF)	Not subject to LCR (<\$50b in wSWTF)

2. Adopts liquidity and Single-Counterparty Credit Limit (SCCL) requirements based on US IHC risk profile:

The final rule revised the proposed SCCL requirements and US Basel III liquidity requirements so that the application of such requirements is based on the risk profile of the US IHC rather than on the risk-profile of its combined US operations.

Requirements	Proposed rule	Final Rule
Single Counterparty Credit Limit	Applicable to FBO's combined US Operations based on the thresholds and risk-based indicators at CUSO level	Applicable to US IHC based on the thresholds and risk-based indicators for the IHC
Standardized Liquidity	Applicable to FBO's combined US Operations based on the thresholds and risk-based indicators at CUSO level	Applicable to US IHC based on the thresholds and risk-based indicators for the IHC

Thresholds matter

The category for capital, liquidity and prudential standards is determined, not only by size of the institution, but also by cross-jurisdictional activity, and/or reliance on short-term wholesale funding, non-bank assets, and off-balance sheet exposure. Additionally, certain requirements may differ within each category depending on these risk-based indicators; whereby firms would remain in the same categories, certain requirements could be reduced or dismissed completely if their indicators demonstrate a reduced level of risk.

Specifically, for FBOs, certain thresholds will apply to the size of its IHC, whereas other requirements are determined by the size of the firm's CUSO activity.

- **Requirements based on an IHC level assets and risk-based indicators**

  For foreign banking organizations, the applicable category of regulatory capital, liquidity and SCCL requirements are measured at the level of the top-tier US intermediate holding company level and applies to any depository institution subsidiary of such holding company for purposes of capital requirements or to any depository institution subsidiary with $10 billion or more in total consolidated assets for liquidity requirements.

- **Requirements based on an CUSO level assets and risk-based indicators**

  For a foreign banking organization, the applicable category of prudential requirements is measured at the CUSO level for internal liquidity stress testing and liquidity risk management requirement.

Significant dedicated focus will be required to manage the various thresholds, measurement points and potential implications.

Categories	Size	Cross-jurisdictional activity	Reliance on short-term wholesale funding, non-bank assets, off-balance sheet exposure
Category II	≥$700b total assets	≥$75b cross jurisdictional activity	N/A
Category III	≥$250b total assets	N/A	≥$75b in nonbank assets, weighted short-term wholesale funding (wSTWF) or off-balance sheet exposure <$75b in weighted short-term wholesale funding are subject to an 85% calibration of LCR
Category IV	Other firms with $100b to $250b total assets	N/A	≥$50b in weighted short-term wholesale funding results in reduced LCR requirements (70%) <$50b in weighted short-term wholesale funding are not subject to LCR requirements
Other FBOs	Between $50 b and $100 b total assets (IHC formation US non-branch assets ≥$50b)	N/A	N/A

Applicable Prudential Standards per category:

Organizations that fall within the four categories would be subjected to the following prudential standards, based on their size and risk profile at IHC level or CUSO level.

Categories	Applicability level	Prudential Standards
Category II	**IHC**	Category II firms would be subjected to the applicable capital, liquidity and SCCL requirements as well as the new NSFR when it is finalized.
	CUSO	Category II firms would be subjected to liquidity stress Testing (monthly), liquidity risk management requirement and would require to report FR 2052a on a daily basis
Category III	**IHC**	Category III firms would be subjected to the same capital requirements and SCCL requirements as Category II firms except: • Not subjected to the advanced approaches capital requirements • Conduct a company-run stress test on a bi-annual basis, • Be able to opt out of Accumulated Other Comprehensive Income (AOCI) • Subjected to reduced LCR and net stability funding ratio if wSTWF<$75b
	CUSO	Category III firms would • Be subjected to the same liquidity stress testing requirements as Category II firms • Be subjected to the same liquidity risk management requirements as Category II firms • Report FR 2052a monthly if wSTWF<$75b; otherwise daily
Category IV	**IHC**	Category IV firms would: • No longer required to complete company-run stress tests • Complete supervisory stress tests on a two-year cycle. • Be exempt from calculating a supplementary leverage ratio • No requirement to maintain countercyclical buffer • Be exempt from IHC level SCCL • Subjected to reduced LCR and net stability funding ratio if wSTWF ≥ $50b and <$75b • Be exempt from LCR and net stability funding ratios if their wSTWF <$50b
	CUSO	Category IV firms would: • Be subject to relaxed timelines for internal liquidity requirements (stress tests, risk management, and reporting) • Report FR 2052a monthly
Other FBOs	**IHC**	• Non-branch US assets are $50 billion are greater, the firms are required to form a IHC. These firms would not have been subject to Category II, III, or IV capital standards, but would have remained subject to the risk-based and leverage capital requirements that apply to a US bank holding company of a similar size and risk profile under the Board's capital rule.
	CUSO	FBOs that do not qualify for Categories II-IV based on their risk profile and: • Global asset are greater than $250 billion and combined US assets of less than $100 billion must certify it meets capital adequacy standards on a consolidated basis and SCCL requirements established by its home-country supervisor • Global assets are greater than $100bn and at least $50 billion but less than $100 billion in combined US assets are subjected to more detailed risk-committee and risk-management requirements, which include the chief risk officer requirement • Global assets are greater than $100bn but less than $50 billion in combined US assets are required to certify on an annual basis that they maintain a qualifying risk committee that oversees the risk management policies of the combined US operations of the foreign banking organization.

Key takeaways:

- **FBO EPS tailoring is modest:** The risk management requirements for Large Institution Supervision Coordination Committee (LISCC) firms and large FBO (LFBO) firms would remain the same. Specifically, the risk requirements include formation of US Risk Committee and appointment of Chief Risk Officer. Relief was provided to FBOs with less than $100 billion in US assets in terms of regulatory requirements such as Comprehensive Capital Analysis and Review (CCAR) and company-run and supervisory stress testing.
- **Liquidity requirements and SCCL based only on IHC risk profile :** As one of the few exceptions from the proposed rule, the Final Tailoring Rules will apply the liquidity requirements and the SCCL requirements to a US IHC based solely on the thresholds and risk-based indicators of the US IHC rather than those of the FBO's CUSO, which include any US branches and agencies of the FBO.

Key takeaways (continued):

- **Tailoring supervision vs. regulation:** For supervision, examiners continue to exercise a great deal of judgement in interpreting how well institutions are adhering to rules or guidance based on their own judgements regarding a firm's quality of management relative to its complexity and risk. That is unlikely to change, though expectations will be better delineated by category of company. At present, supervision programs continue to bucket firms into systemic banks, large regionals, foreign entities, and community organizations, and these supervision groupings may be more fully defined and segregated based on the new thresholds. Moreover, currently examination procedures and supervisory strategies are geared towards the broader institution types. Systemic firms and large regional firms receive horizontal supervisory reviews that allow supervisors to compare practices across firms and establish a consistent bar around what is considered a safe and sound practice. The topics and intensity of reviews of course are different depending on the portfolio type.[7]

- **Category IV impact is where tailoring is most evident:** The only difference in capital requirements between Category II and Category III is the frequency of company-run stress tests (annual versus a two-year cycle, respectively). Category IV firms would find the biggest relief. Note even though category IV firms don't require to complete company-run stress tests and complete supervisory stress tests on a two-year cycle, agencies will continue to supervise during off cycle.

- **Liquidity Requirements specific to CUSO:** CUSO will be subject to enhanced liquidity risk management standard and have the requirements to cover a minimum of 30 days of outflows based on internal liquidity stress test.

- **Calibration for liquidity requirements:** LCR standards for foreign domestic firms were originally proposed to be reduced between 70-85% for certain category III and IV companies. The final rule reduces LCR requirement by 15% for Category III institutions if they have less than $75 billion in wSTWF and by 30% for Category IV institutions with more than $50 billion in wSTWF.

- **Additional thresholds:** The framework is a complex web of thresholds to model and monitor and require considerable effort to interpret and digest the rules; complicating peer comparisons initially (since the FRB provided initial categorizations for specific FBOs – *See next page for details*) and going forward. The new definitions will create additional data gathering needs and aggregation efforts (e.g. the CUSO data changes) across reporting including the FR Y-15 and emphasize FRY-9C reporting.[8] Institutions will need to understand the thresholds that apply to their FBO[9] and monitor them holistically going forward not only as part of business as usual but also as part of new business/new product analysis as appropriate. Substantial training/awareness will likely be required on an ongoing basis for US and Parent level executives. Regular reporting capabilities will be leveraged for regulatory reporting but also will be needed for internal monitoring.

- **Branch liquidity rules – impact is TBD:** The FRB deferred the decision but requested comments on whether standardized liquidity requirements should be imposed on US branches and agencies of FBOs, and what would be the approaches for doing so. For years, the FRB has discussed addressing this risk by proposing the application of standardized liquidity requirements to the branches and agencies of foreign banks, which would reduce the incentive to shift assets to branches from IHCs. In fact, branch assets have grown as a percentage of foreign bank activities in the United States since the IHC requirements were put in place, and the US branches and agencies of foreign banks rely roughly twice as much on short-term wholesale funding as the US IHCs.

- **Evaluating in a controlled manner:** Institutions receiving relief should evaluate how changes in standards should be factored into medium term strategies for US Operations, proforma for current and expected activity and only unwound in a controlled and measured manner while ensuring that fundamental risk management that intersects with these areas is not unintentionally degraded and that unnecessary rework is avoided. It's important to note that while there has been relief in the rules applied to institutions, the intensity of examiner scrutiny and level of expectations appears to have lightened only modestly, and for some of the systemic firms may have increased in some areas. Regardless of the new tailoring category a firm may find itself within, examiner scrutiny of the basic blocking and tackling of risk management and related capabilities is unlikely to lighten appreciably in the near future.

Final rule summary

<table>
<tr><th colspan="3" rowspan="2">Application of capital, liquidity, and other Enhanced Prudential Standards (EPS) for FBOs (determined based on an IHC level assets and risk-based indicators)</th><th>Category II</th><th>Category III</th><th>Category IV</th><th rowspan="2">FBOs with $50b to $100b IHC assets and ≥ $100b global assets</th></tr>
<tr><th>≥ $700b IHC Assets or ≥ $75b in cross-jurisdictional activity (or, for Liquidity reqs. ≥ $75b in IHC wSTWF)</th><th>≥ $250b IHC assets or ≥ $75b in nonbank assets, wSTWF, or off-balance sheet exposure (or, for Liquidity Reqs, with < $75b in IHC wSTWF)</th><th>Other firms with $100b to $250b IHC assets</th></tr>
<tr><td colspan="2">IHC</td><td>US IHC Requirement</td><td colspan="4">✓</td></tr>
<tr><td rowspan="7">CAPITAL</td><td rowspan="3">Stress Testing</td><td>Company-run stress testing</td><td>✓
(Annual)</td><td>✓
(Every two years)</td><td></td><td></td></tr>
<tr><td>Supervisory stress testing</td><td colspan="2">✓
(Annual)</td><td>✓
(Every two years)</td><td></td></tr>
<tr><td>Capital plan submission (annual)</td><td colspan="3">✓</td><td></td></tr>
<tr><td rowspan="3">Risk-based capital</td><td>Advance approaches</td><td>✓</td><td></td><td></td><td></td></tr>
<tr><td>Countercyclical Buffer</td><td colspan="2">✓</td><td></td><td></td></tr>
<tr><td>Opt-out of AOCI capital impact</td><td></td><td colspan="3">✓</td></tr>
<tr><td>Leverage Capital</td><td>Supplementary leverage ratio</td><td colspan="2">✓</td><td></td><td></td></tr>
<tr><td rowspan="2">LIQUIDITY</td><td rowspan="2">Standardized Liquidity</td><td>Liquidity coverage ratio</td><td>✓
(Daily)</td><td>✓
(Reduced unless >$75b in wSTWF)</td><td>✓
(Reduced if ≥ $50b in wSTWF)</td><td></td></tr>
<tr><td>Net stability funding ratio (proposed)*</td><td>✓
(Daily)</td><td>✓
(Reduced unless >$75b in wSTWF)</td><td>✓
(Reduced if ≥ $50b in wSTWF)</td><td></td></tr>
<tr><td rowspan="2">OTHER EPS</td><td rowspan="2">SCCL</td><td>Home Country SCCL consistent with BASEL</td><td colspan="2">✓</td><td colspan="2">✓
(if global assets ≥ $250b)</td></tr>
<tr><td>IHC-level SCCL</td><td colspan="2">✓</td><td></td><td></td></tr>
<tr><th colspan="7">Application of Internal Liquidity Requirements (determined based on the CUSO of FBO)</th></tr>
<tr><td rowspan="3">LIQUIDITY</td><td rowspan="3">Internal Liquidity</td><td>Liquidity stress tests</td><td colspan="2">✓
(Monthly)</td><td>✓
(Quarterly)</td><td>✓
(Home country stress)</td></tr>
<tr><td>Liquidity risk management</td><td colspan="2">✓</td><td>✓
(Reduced)</td><td></td></tr>
<tr><td>Report FR 2052a</td><td>✓
(Daily)</td><td>✓
(Monthly; daily if >$75b in wSTWF)</td><td>✓
(Monthly)</td><td></td></tr>
</table>

* The proposed net stable funding ratio (NSFR) rule will not be finalized as a result of the tailoring final rule

Timeline for initial categorizations and reporting under the final tailoring rule

	Reporting Unit			
	US BHC	**Covered SLHCs**	**US IHC**	**Combined US Operations**
Date for first categorization under tailoring rule	Effective date of final rule	Effective date of final rule	Effective date of final rule	Submission date of FR Y-15 as-of June 30, 2020
First as-of date for amended FR Y-15	June 30, 2020	June 30, 2020	June 30, 2020 *(Top-tier FBO will report the FR Y-15 on behalf of their US IHC and combined US operations.)*	

Summary

The tailoring of EPS for FBOs is intended to "maintain the resilience built up across the US financial system over the past decade, while at the same time making appropriate adjustments for firms that present less risk." as quoted by Chairman Jerome Powell (Apr. 8, 2019), available here. The framework uses several measures to evaluate the risk of a bank. Size will remain a key factor in our evaluation of a firm's overall risk, but the rules add additional measures of risk to our tailoring framework. The tailoring framework. The key purpose of tailoring is to match the "character of regulation to the character of the firm". In approaching this objective for foreign banks, there are two key objectives a) creating a level playing field between foreign banks and domestic firms of similar size and business models, and b) giving due regard to the principle of national treatment. The tailoring rule further: Supports the development of a regulatory framework that more closely ties regulatory requirements to underlying risks, in a way that does not compromise the strong resiliency gains and encourages implementation of materially less stringent requirements on firms with less risk, while maintaining the most stringent requirements for firms that pose the greatest risks to the financial system and our economy. In this way, the rules maintain the fundamental strength and resiliency that has been built into the financial system over the past decade

End Notes

1. https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a1.pdf; https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a2.pdf
2. Opening Statement by Chair Jerome H. Powell (Oct 10, 2019), available at https://www.federalreserve.gov/newsevents/pressreleases/powell-opening-statement-20191010.htm
3. Statement by Governor Lael Brainard https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm
4. The EGRRCPA was signed into law on May 24, 2018. It increased the asset threshold for a banking organization to be designated as a systemically important financial institution (SIFI) from $50 billion to $100 immediately after enactment with a further increase 18 months after enactment.
5. Resolution Planning: https://www.federalreserve.gov/aboutthefed/boardmeetings/files/resolution-plan-rule-fr-notice-20191010.pdf
6. Other risk-based measures include cross-jurisdictional activity, nonbank assets, off balance sheet exposure, and weighted short-term wholesale funding
7. https://www2.deloitte.com/us/en/pages/regulatory/articles/exam-priorities-for-financial-services-firms-in-2018.html
8. Federal Reserve: FR Y-15 Banking Organization Systemic Risk Report Blog (To be published)
9. Pls refer to "Categorization of initial FRB view for FBOs based on the final FBO tailoring rule" (Source: https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-board-memo-20191010.pdf) and "Timeline for Initial Categorizations and Reporting Under the Final Tailoring Rule" (Source: https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a2.pdf)

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