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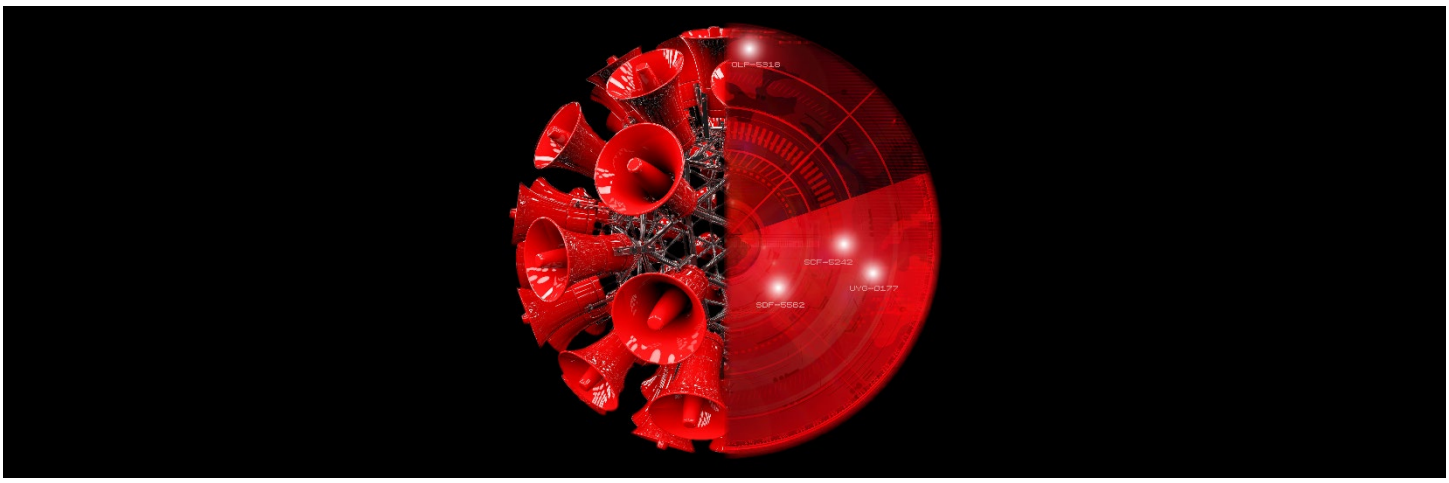

Federal Reserve Board proposes tailoring Prudential Standards for large banking institutions

On October 31, 2018, the Federal Reserve Board ("the FRB") proposed tailoring the post-crisis regulatory framework for large, domestic banking institutions known as Enhanced Prudential Standards ("EPS"). According to Chairman Jay Powell, this approach reflects the spirit of the Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA") by prescribing "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."

Applicability

The proposed framework includes two proposals: one issued exclusively by the FRB, and another issued jointly with the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC"). The proposals apply to all domestic bank holding companies (BHCs) and non-insurance, non-commercial savings and loan holding companies (SLHCs) with more than $100 billion in total consolidated assets. The proposals do not apply to foreign banking organizations ("FBOs") or any intermediate holding company ("IHC") of an FBO. The FRB has indicated that it plans to "develop a separate proposal relating to [FBOs] and their U.S. operations."

Key takeaways

- **Prudential standard categories -** The proposals assign large banking organizations to one of four categories each with its own set of tailored requirements. The criteria for the categories are set forth below in order of descending level of regulatory strictness:
    - **Category I:** applies to US global systemically important banks ("G-SIBs"). The agencies would use the current methodology under the FRB's G-SIB surcharge rule to determine applicability.
    - **Category II:** applies to organizations that are not classified as US G-SIBs and have more than $700 billion in total consolidated assets or organizations that have at least $100 billion in total consolidated assets and $75 billion in cross-jurisdictional activity.

    - **Category III:** applies to organizations to which categories I-II do not apply and that have more than $250 billion in total consolidated assets or more than $75 billion in one of the following three categories: weighted short-term wholesale funding, nonbank assets, and off-balance sheet exposure.
    - **Category IV:** applies to all organizations with at least $100 billion in total consolidated assets that do not apply to categories I-III.

- **FRB goes beyond EGRRCPA -** The proposal goes beyond EGRRCPA by tailoring standards for firms between $250-700 billion (EGRRCPA only indicated a change for $100 to $250 billion). It is noted that Governor Lael Brainard objected to the proposal for going beyond the legislative mandate, particularly regarding the liquidity coverage ratio ("LCR"). The vote was 3-1 to move forward with the proposal.

- **Size and other risk-based indicators** - The proposals would modify the applicability of EPS by focusing on additional risk factors and not size alone. These additional indicators are:
    - **Size:** measured by total consolidated assets
    - **Status as a US G-SIB:** measured by the current methodology under the FRB's G-SIB surcharge rule.
    - **Cross-jurisdictional activity:** measured by the sum of cross-jurisdictional assets and liabilities, as measured on FR Y-15.
    - **Weighted short-term wholesale funding:** consistent with the measure used to calculate the G-SIB surcharge rule, as reported on FR Y-15.
    - **Nonbank assets:** Consistent with the calculation used for the FRB's capital plan rule, as reported on FR Y-9LP.
    - **Off-balance sheet exposures:** measured as total exposure less total consolidated assets, as reported on FR Y-9C.
    - Holding companies and depository institutions would be responsible for determining the category of standards to which they belong. Firms would be subject to report size and other risk-based indicators on a quarterly basis, based off the average of the preceding four quarters.

- **Capital plan** - All firms above $100 billion in total consolidated assets still must submit an annual capital plan to the FRB. In addition, Category IV $100-250 billion firms will still be subject to the quantitative portion of Comprehensive Capital Analysis and Review ("CCAR") results of the firm's internal CCAR stress test would be published publicly every other year along with the FRB's stress test CCAR results, but without a qualitative review.

- **Basel capital** – Category III and IV firms (e.g., most firms below 700 billion) will not be subject to the Basel advanced approaches.

- **Risk profiles can expose a firm to higher prudential standards:** A firm with less than $250 billion in total consolidated assets but more than $75 billion of any risk indicator would create an additional regulatory burden including, but not limited to, more frequent reporting (daily FR 2052a), higher required ratios (e.g., LCR and supplementary coverage ratio), and more intensive regulatory scrutiny (CCAR Qualitative Review).

- **Level of cross-jurisdictional activity remains key** - The FRB reinforced its message for systemic risk stemming from global complexity and interconnectedness. A bank with more than $700 billion in total consolidated assets or any bank with over $100 billion in total consolidated assets and more than $75 billion in cross-jurisdictional activity qualifies for Category II. Category II is nearly the same as Category I, with the exception that it technically is not a G-SIB.

Net-net - applicable prudential standards

Organizations that fall within the four categories would be subjected to the following prudential standards, based on their size and risk profile. The appendix includes a detailed list of requirements by category:

- **Category I:** G-SIB firms would be subject to the currently applicable capital and liquidity requirements. Additionally, EGRRCPA amended Dodd-Frank's requirement for G-SIB firms to conduct an off-cycle company-run stress test to an annual test beginning with the 2020 cycle.
- **Category II:** Category II firms would be subject to the same capital and liquidity requirements applicable to Category I firms, apart from the G-SIB surcharge, Total Loss Absorbing Capacity ("TLAC") long term debt requirements. In addition, Category II firms would not be subject to the enhanced supplementary leverage ratio ("eSLR") but the supplementary leverage ratio would still apply.
- **Category III:** Category III firms would no longer be required to conduct company-run annual stress tests. In addition, these firms would no longer be subject to the advanced approaches capital requirements or the requirement to recognize the Accumulated Other Comprehensive Income (AOCI) in regulatory capital.
- **Category IV:** In addition to the capital requirements from which Category III firms would be exempt, Category IV firms would be exempt from the supplementary leverage ratio and the countercyclical capital buffer. In addition, these firms would be subject to a two-year cycle for CCAR Quantitative Assessments and supervisory stress testing. Category IV firms would not be subject to any LCR or Net Stable Funding Ratio ("NSFR") requirements and would be required to conduct quarterly liquidity stress tests (as compared to monthly tests). These firms would be able to conduct tailored liquidity risk management and monthly FR 2052a reporting.
- **All categories:** EPS maintains risk committee and related risk management categories which are maintained throughout the proposals. Apart from Category IV, all categories would be subject to single-counterparty credit limits.

Regulatory proposals still to come – The two proposals reference several upcoming regulatory actions. Institutions will need to continue to monitor regulatory developments, study proposals, and anticipate changes:

- **FBOs** – The FRB indicated that it would release a similar tailoring proposal for FBOs, even though FBOs were not originally included in the EGRRCPA. The FRB's Proposal notes that any proposal adjusting the application of the post-crisis regulatory framework for FBOs will "reflect the principles of national treatment and equal competitive opportunity." The agencies are considering "the appropriate way to assign the US operations of [FBOs] to the categories . . . described in the[e] proposal[s], in light of the special structures through which these firms conduct business in the United States." FRB Chair Powell and Vice Chair Quarles have previously indicated that they did not expect to adjust thresholds for FBOs.
- **Resolution planning** – The FRB Proposal references a joint proposal with the FDIC adjustments to resolution planning requirements for BHCs between $100-250 billion in total consolidated assets. Expectations surrounding this proposal include formalizing submissions every 2 years, primarily focusing on material changes and new areas of interest.
- **Stress testing:** The FRB has indicated that NSFR is close to finalization and would plan to release several proposals related to stress testing.
- **eSLR:** The FRB has yet to finalize its proposal to adjust the eSLR – the one proposal that would benefit the US G-SIBs.

Conclusion

The proposed tailoring of EPS is intended to provide "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." Firms subject to the tailoring should analyze their business profiles and risk characteristics relative to the proposed categories for opportunities to calibrate their business models.

Industry comments are due January 22, 2019.

Appendix

Proposed capital, liquidity, and other Enhanced Prudential Standards (EPS) for large banking institutions			Category I US G-SIBs	Category II ≥$700b total assets or ≥$75b cross jurisdictional activity	Category III ≥$250b total assets or ≥$75b in nonbank assets, weighted short-term wholesale funding (wSTWF) or off-balance sheet exposure	Category IV Other firms with $100b to $250b total assets
Capital	TLAC	TLAC/Long-term debt	✓			
	Stress testing	Stress testing: Company run (DFAST)	✓ (Annual)	✓ (Annual)	✓ (Every two years)	
		Stress testing: Supervisory	✓ (Annual)	✓ (Annual)	✓ (Annual)	✓ (Every two years)
		CCAR: Quantitative	✓	✓	✓	✓ (Every two years)
		CCAR: Qualitative	✓	✓	✓	
	Risk-based capital	Annual capital plan submission	✓	✓	✓	✓
		G-SIB surcharge	✓			
		Advanced approaches	✓	✓		
		Countercyclical capital buffer	✓	✓	✓	
		Opt-out of AOCI capital impact			✓	✓
	Leverage capital	Supplementary leverage ratio	✓ (enhanced)	✓	✓	
Liquidity	Standardized	Liquidity coverage ratio	✓	✓	✓ (Reduced unless >$75b in wSTWF)	
		Net stability funding ratio (proposed)	✓	✓	✓ (Reduced unless >$75b in wSTWF)	
	Internal	Liquidity stress tests	✓ (Monthly)	✓ (Monthly)	✓ (Monthly)	✓ (Quarterly)
		Liquidity risk management	✓	✓	✓	✓ (Tailored)
		Liquidity buffer	✓	✓	✓	✓
		FR 2052a reporting	✓ (Daily)	✓ (Daily)	✓ (Monthly; daily if >$75b in wSTWF)	✓ (Monthly)
Other EPS		Risk committee	✓	✓	✓	✓
		Risk management	✓	✓	✓	✓
		Single-counterparty credit limit	✓ (G-SIB specific requirements)	✓	✓	

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Endnotes

[1] The EGRRCPA was signed into law on May 24. 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.

[2] Chairman Jerome Powell, Opening Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations (Oct. 31, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/powell-opening-statement20181031.htm.

[3] Board of Governors of the Federal Reserve System, Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies (Oct. 31, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181031a2.pdf (hereinafter the "FRB Proposal").
and
Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements (Oct. 31, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181031a1.pdf (hereinafter the "Interagency Proposal"). The OCC adopted the Interagency Proposal on October 31, 2018.

[4] Interagency Proposal, page 17 (footnote 18).

[5] Governor Lael Brainard, Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations (Oct. 31, 2018), available at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm

[6] FRB Proposal, pages 14-15.

[7] Interagency Proposal, page 17 (footnote 18); FRB, page 14.

[8] FRB Proposal, page 11.

[9] FRB Proposal, pages 11, 55, and 58.

[10] Chairman Jerome Powell, Opening Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations.