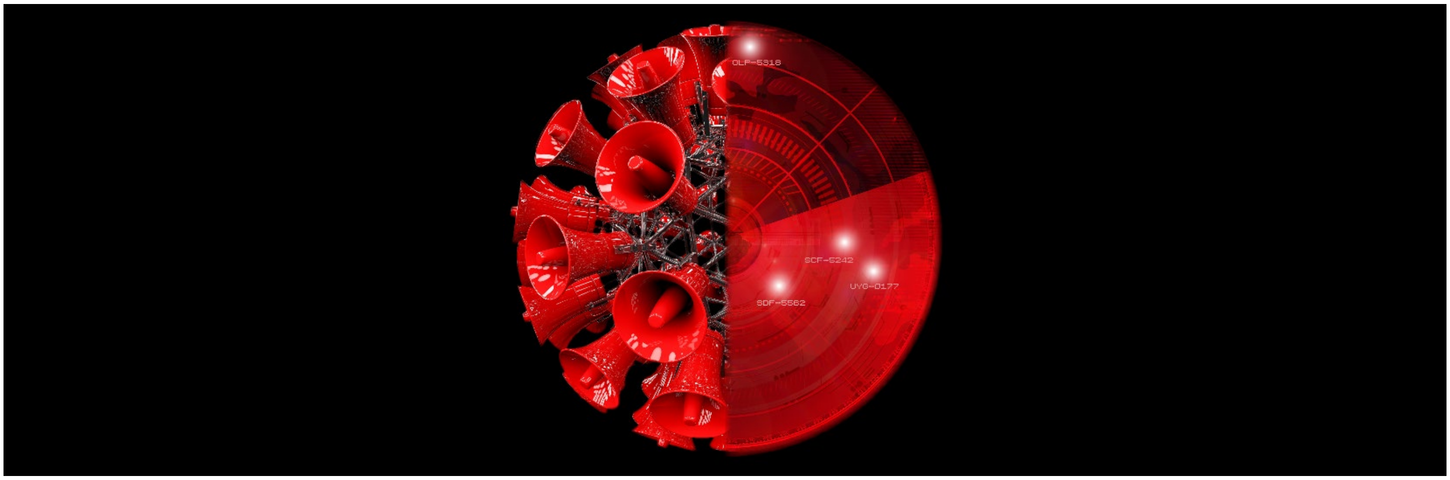

Federal Reserve Board finalized tailoring Prudential Standards for large banking institutions

On October 10th, 2019, the Federal Reserve Board (FRB) finalized the tailoring of 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)[1] 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."[2] In the Final Rules opening statement, Chairman Jay Powell solidified that the final rules "tailor our enhanced prudential standards to match the overall risk profiles of large domestic and foreign banks."[3] During board discussions it was stressed that although a regulatory burden may have been lifted for smaller and less complex firms, this is not a relief for foundational capital, liquidity, and risk management expectations, or from ongoing supervision from the regulators.

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) and in some cases provides tailoring relief beyond that in the legislation; that legislation gave the Fed greater discretion to tailor or eliminate EPS requirements. In a complementary rulemaking, the Federal Reserve and FDIC also tailored requirements related to resolution plans or "living wills" in a similar manner.[4] 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 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 have 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 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. A separate framework was issued for foreign banking organizations (FBOs) or any international holding company (IHC) of an FBO. The framework goes beyond EGRRCPA by tailoring standards for firms between $250-700 billion (EGRRCPA only indicated a change for $100 to $250 billion).

Final Rule remains consistent with the proposed framework

The final rule assigns banks to one of four categories each with its own set of tailored requirements, as measured by size and other risk-based measures.[5] Organizations that fall within the four categories are subjected to the following prudential standards, based on their size and risk profile.

The final rule remained largely aligned with proposed framework presented on October 31st, 2018, with one exception.

Reduced standardized liquidity requirement:

The final framework reduced standardized liquidity requirements for domestic and foreign firms subject to Category III and IV standards. The proposed range was calibrated from 70 to 85 percent based on weighted short-term wholesale funding (wSTWF). The draft final rules would include the following calibrations to reflect the difference in the risk profiles of these firms:

	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)

Thresholds matter

The category for 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 remain in the same categories, certain requirements could be reduced or dismissed completely if their indicators demonstrate a reduced level of risk.

Categories	Size	Cross-jurisdictional activity	Reliance on short-term wholesale funding, non-bank assets, and off-balance sheet exposure
Category I	U.S. GSIBs*		
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

* Under the FRB guidelines

Applicable Prudential Standards per category:

Organizations that fall within the four categories are subjected to the following prudential standards, based on their size and risk profile. Additionally, EPS maintains a risk committee and related risk management categories which are maintained throughout the framework. Apart from Category IV, all categories are subject to single-counterparty credit limits.

Categories	Prudential Standards
Category I	G-SIB firms are 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 are subject to the same capital and liquidity requirements applicable to Category I firms, apart from the G-SIB surcharge, TLAC long term debt requirements. In addition, Category II firms are not subject to the enhanced supplementary leverage ratio ("eSLR") but the supplementary leverage ratio still apply.
Category III	Category III firms are no longer be required to conduct company-run annual stress tests. In addition, these firms are no longer subjected 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 are exempt, Category IV firms are exempt from the supplementary leverage ratio and the countercyclical capital buffer. In addition, these firms are subject to a two-year cycle for CCAR Quantitative Assessments and supervisory stress testing. Category IV firms are not subjected to any LCR or Net Stable Funding Ratio ("NSFR") requirements and are required to conduct quarterly liquidity stress tests (as compared to monthly tests). These firms can conduct tailored liquidity risk management and monthly FR 2052a reporting.

Key takeaways:

- **Revised framework for application of Prudential Standards -** The final rule largely remains align with the proposed rules which were released in October, 2018. The final rules assigns large banking organizations to one of four categories each with its own set of tailored requirements, as described in the 'Threshold Matter' section.

- **Accumulated Other Comprehensive Income (AOCI)** – The final rule allows some banking organizations subject to Category III standards which were previously required to include elements of accumulated other comprehensive income (AOCI) in regulatory capital, to now elect to exclude most elements of AOCI from regulatory capital.

- **Size and other risk based indicators** - The final rule modifies the applicability of EPS by focusing on additional risk factors and not size alone. These indicators are: Status as a US G-SIB; Cross-Jurisdictional Activity; Reliance on Short-term wholesale funding; Nonbank assets; Off-balance sheet exposures; and Thresholds calculations.

- **Capital requirements** – Categories III-IV firms requirements decreased by approximately 0.6% of total risk-weighted assets, reducing the compliance cost related to stress testing and, for certain firms, the advanced approaches capital requirements. Additionally, they are not be subject to internal models-based risk-based capital requirements.

- **Liquidity requirements** – Requirements for Category III-IV firms are modified, estimating a reduction of liquidity requirements by about 2% for these domestic holding companies.

- **Liquidity Coverage Ratio (LCR)** – Category III firms with a lower reliance on short-term wholesale funding are subject to reduced LCR, calibrated at 85% of the full requirement, while firms with weighted short-term funding of $75 billion or more are subject to 100% LCR requirements. Generally, Category IV firms are not subject to an LCR requirement.

Key takeaways (continued):

- **Stress testing** – The mid-cycle stress testing requirements are eliminated for all firms, including U.S. GSIBs; however, the rule provides flexibility to the Board to adjust the required frequency at which a firm must conduct stress tests. Category III firms are required to publicly report the results of a company-run stress test every two years, instead of semi-annually. Additionally, Category IV firms are subject to supervisory stress testing every two years, rather than annually, and are no longer required to conduct and publicly report the results of a company-run stress test.

- **Capital plan** – All firms above $100 billion in total consolidated assets must still submit an annual capital plan to the FRB. Therefore, although the FRB relaxed requirements around stress testing, particularly for Category IV firms, expectations of strong and robust capital planning practices remain part of requirements and core supervisory expectations are not reduced.

- **Matching of regulatory burden to risk profiles** – The FRB aimed to develop a regulatory framework that ties more closely with underlying risks, without compromising the strong resiliency gains made since the financial crisis, maintaining existing requirements in place for the largest and most complex Category I-II firms, while reducing the regulatory burden on Category III-IV firms

- **Changes of category of standard** – The determination of a firm's category of standards is based on the average levels of each indicator reported over the preceding four calendar quarters, providing ample time for firms to prepare for increased requirements when a threshold is expected to be crossed

Final rule summary

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

Summary

The tailoring of EPS for US Bank Holding Companies (BHCs) 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 the evaluation of a firm's overall risk. The key purpose of tailoring is to match the "character of regulation to the character of the firm". In approaching this objective, 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. 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 less complex firms. 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

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 systemic firms, while smaller firms have received modest to substantial relief.

End notes:

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. Chairman Jerome Powell, Opening Statement on Final Rules to Tailor Enhanced Prudential Standards and Resolution Plan Requirements for Large Domestic and Foreign Banks (Oct. 10, 2019) available at https://www.federalreserve.gov/newsevents/pressreleases/powell-opening-statement-20191010.htm
4. Resolution Planning: https://www.federalreserve.gov/aboutthefed/boardmeetings/files/resolution-plan-rule-fr-notice-20191010.pdf
5. Other risk-based measures include cross-jurisdictional activity, nonbank assets, off balance sheet exposure, and weighted short-term wholesale funding

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