SIMPSON THACHER MEMORANDUM

# Regulating Systemically Important Financial Companies

## *Federal Reserve Issues Proposed Rule on Enhanced Prudential Standards and Early Remediation Framework for Systemically Important Financial Organizations*

*January 10, 2012*

The Board of Governors of the Federal Reserve System (the "Federal Reserve") has released a much-awaited proposal (the "Proposed Rule") on the enhanced prudential standards and early remediation framework that will apply to (i) large bank holding companies with $50 billion or more in total consolidated assets and (ii) nonbank financial companies designated by the new Financial Stability Oversight Council (the "FSOC") as systemically important (collectively, "Covered Companies"). The Proposed Rule would implement Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") and, together with other rulemakings, form the heart of systemic risk regulation under Dodd-Frank. Comments on the Proposed Rule, which was published last week in the Federal Register, are due by March 31, 2012.

As described below, the Proposed Rule sets forth:

- risk-based capital requirements and leverage limits;
- liquidity requirements;
- single-counterparty exposure limits;
- risk management and risk committee requirements;
- stress testing requirements;
- debt-to-equity limits for certain Covered Companies; and
- an early remediation framework.

The requirements under the Proposed Rule generally become effective on the first day of the fifth calendar quarter after the date on which the Proposed Rule becomes effective (or the date on which a company becomes a Covered Company), although certain requirements are subject to delayed effectiveness and transition periods.

In addition to the requirements contained in the Proposed Rule, Dodd-Frank requires the Federal Reserve to implement resolution plan and credit exposure report requirements with respect to Covered Companies. These requirements are not part of the Proposed Rule because the Federal Reserve and the Federal Deposit Insurance Corporation (the "FDIC") have already implemented the resolution plan requirement, effective November 30, 2011, and are expected to implement the periodic reporting of credit exposures in a separate rulemaking. The Proposed Rule also does not cover various supplemental prudential standards listed in Dodd-Frank that the Federal Reserve is authorized, but not required, to impose on Covered Companies. These standards relate to contingent capital, public disclosures, short-term debt limits and such other prudential standards the Federal Reserve determines are appropriate. In the background material accompanying the Proposed Rule, the Federal Reserve indicated that it continues to consider whether it should adopt any of these standards.

## A. BACKGROUND AND SCOPE OF APPLICATION

The Proposed Rule would create an "integrated set of requirements" to "meaningfully reduce" the probability of a systemically important financial company failing and to minimize damage to the U.S. financial system in the event such a company does fail. The requirements set forth by the Federal Reserve are designed to increase in stringency with the level of systemic risk posed by a particular Covered Company. Notably, the Federal Reserve characterizes the Proposed Rule as providing "incentives" for Covered Companies to "reduce their systemic footprint."

As noted above, the Proposed Rule would apply to Covered Companies, which are those bank holding companies that have $50 billion or more in total consolidated assets and those nonbank financial companies that have been designated by the FSOC as systemically important. Certain requirements, such as the risk committee and annual stress testing requirements, would also apply to bank holding companies with $10 billion or more in total consolidated assets. As proposed, the Federal Reserve would generally apply the same set of enhanced prudential standards to Covered Companies that are bank holding companies and Covered Companies that are nonbank financial companies; however, the Federal Reserve will have the discretion to "tailor" the application of the standards to different companies, on an individual basis or by category, taking into consideration such things as capital structure, riskiness, complexity, financial activities, size and any other risk-related factors that the Federal Reserve deems appropriate.

Although Sections 165 and 166 of Dodd-Frank also apply to foreign banking organizations ("FBOs") that have $50 billion or more in total consolidated assets or are treated as bank holding companies pursuant to Section 8(a) of the International Banking Act, the Proposed Rule does not cover FBOs. The Federal Reserve is expected to issue a separate rulemaking regarding the application of the enhanced prudential standards and early remediation requirements to these organizations. With regard to U.S. bank holding company subsidiaries of FBOs that have relied on the Federal Reserve's Supervision and Regulation Letter SR 01-01, the Proposed Rule generally does not apply to these companies until July 21, 2015, with the exception of the proposed liquidity and risk management requirements and the debt-to-equity limit, which are described below.

Sections 165 and 166 of Dodd-Frank do not generally apply to savings and loan holding companies unless they are otherwise designated as systemically important by the FSOC or, in the case of the annual stress testing requirement, have $10 billion or more in total consolidated assets. However, the Federal Reserve, as the new primary regulator of such companies, intends to issue a separate proposal to initially apply the enhanced prudential standards and early remediation requirements to savings and loan holding companies that have $50 billion or more in total consolidated assets and "substantial banking activities" (*i.e.*, where thrift subsidiaries comprise 25% or more of such company's assets or themselves have $50 billion or more in assets).

## B. RISK-BASED CAPITAL REQUIREMENTS AND LEVERAGE LIMITS

Both Dodd-Frank and the new Basel III capital framework reflect the view that the amount of capital held by many large, complex banking companies prior to the recent financial crisis was inadequate for the risk. Dodd-Frank directs the Federal Reserve to establish enhanced risk-based capital and leverage standards for Covered Companies to address these weaknesses. Consistent with this mandate, the Federal Reserve proposes a two-part effort. First, the Federal Reserve would subject all Covered Companies to enhanced risk-based capital and leverage requirements by means of the Federal Reserve's capital plan rule, which was introduced in November 2011. And second, through implementation of guidance issued by the Basel Committee on Banking Supervision ("BCBS"), the Federal Reserve proposes to implement a quantitative risk-based capital surcharge for Covered Companies (or a subset thereof).

### 1. Enhanced Risk-Based Capital and Leverage Requirements

Under the capital plan rule, Covered Companies will have to demonstrate to the Federal Reserve that they have robust, forward-looking capital planning processes, including stress-testing, that account for their unique risks and that permit continued operations during times of economic and financial stress. In particular, Covered Companies will be required to demonstrate to the Federal Reserve their ability to maintain capital above existing minimum regulatory capital ratios[1] and above a Tier 1 common ratio of 5% under both expected and stressed conditions over a minimum nine-quarter planning horizon.[2] Covered Companies with unsatisfactory capital plans will face limits on their abilities to make capital distributions.

The Proposed Rule contemplates that nonbank Covered Companies will be subject to the same minimum risk-based and leverage capital (and regulatory reporting) requirements applicable to Covered Companies that are bank holding companies, although the Proposed Rule acknowledges that some aspects of these capital requirements may not take into account the characteristics of activities and assets of nonbank Covered Companies that are impermissible for banks and bank holding companies. The Federal Reserve may consider whether any

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1 At present, the Federal Reserve's rules for calculating minimum capital requirements are found at 12 C.F.R. Part 225, App. A (general risk-based capital rule), 12 C.F.R. Part 225, App. D (leverage rule), 12 C.F.R. Part 225, App. E (market risk rule), and 12 C.F.R. Part 225, App. G (advanced approaches risk-based capital rule). As a consequence of the so-called "Collins Amendment" of Dodd-Frank, a firm that meets the applicability thresholds under the market risk rule or the advanced approaches risk-based capital rule is required to use those rules to calculate its minimum risk-based capital requirements, in addition to the general risk-based capital requirements and the leverage rule.

2 Under the capital plan rule, Tier 1 common is defined as Tier 1 capital less non-common elements in Tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.

adjustments to the minimum capital requirements applicable to a nonbank Covered Company may be appropriate, within the limits of its statutory authority. The Federal Reserve is seeking comments on the appropriateness of requiring nonbank Covered Companies to have the same capital planning, stress testing and regulatory capital requirements as bank holding companies.

2. <u>Capital Surcharge for Certain Covered Financial Companies</u>

Over the past few years, the Federal Reserve and other U.S. federal banking agencies have worked together with the BCBS to strengthen the regulatory capital regime for internationally active banks.[3] The Federal Reserve is working with the other U.S. banking regulators to implement the resulting Basel III capital reforms in the United States.

Building on the Basel III reforms, the BCBS published a document in November 2011 that establishes an additional capital requirement for approximately 30 global systemically important banks ("G-SIBs"). The BCBS would require G-SIBs to hold an additional amount of common equity above the regulatory minimums to enhance their resiliency and ability to absorb losses under difficult economic conditions. The recently finalized framework establishes a special capital surcharge, ranging from 100 to 350 basis points, based on a twelve-factor formula for measuring systemic risk.

The Federal Reserve's Proposed Rule embraces this surcharge concept, noting that "[a] capital surcharge would help require that these companies account for the costs they impose on the broader financial system and would reduce the implicit subsidy they enjoy due to market perceptions of their systemic importance." The Federal Reserve intends to adopt implementing rules in 2014 for a quantitative risk-based capital surcharge for Covered Companies, with capital surcharges becoming effective on a phased-in basis from 2016-2019.

## C. LIQUIDITY REQUIREMENTS

Dodd-Frank and Basel III also reflect the view that significant weaknesses in liquidity buffers and liquidity risk management practices throughout the financial system contributed to the failure or near failure of a number of companies and exacerbated the crisis. Dodd-Frank addresses inadequacies in the existing regulatory liquidity requirements by directing the Federal Reserve to establish liquidity standards for Covered Companies. Similar to enhanced risk-based capital and leverage requirements, the Federal Reserve intends to implement this statutory requirement through a multi-stage approach. First, the Proposed Rule would subject Covered Companies to a set of enhanced liquidity risk management standards, including liquidity stress testing, which build on guidance previously adopted by the Federal Reserve and other U.S. federal banking agencies. Higher liquidity risk management standards would apply

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3 The new regime for internationally active banks, known as Basel III, seeks to improve the quality of regulatory capital and introduces a new minimum common equity requirement. Basel III also raises the numerical minimum capital requirements and introduces capital conservation and countercyclical buffers to induce banking organizations to hold capital in excess of regulatory minimums. In addition, Basel III establishes for the first time an international leverage standard for internationally active banks.

to Covered Companies. Second, the Federal Reserve proposes, at a later date, to issue regulations establishing quantitative liquidity requirements for Covered Companies that are consistent with those currently being tested by the BCBS.

1. Enhanced Liquidity Risk Management Standards

In the first stage, Covered Companies would be subject to enhanced liquidity risk management standards that build upon existing supervisory guidance. The Proposed Rule would require a Covered Company to take a number of prudential steps to manage liquidity risk, including requirements to:

- establish effective corporate governance, consisting of oversight of the Covered Company's liquidity risk management by its board of directors, senior management and an independent review function;
- produce specific liquidity management processes, cushions and measures, including detailed cash flow projections, liquidity stress testing and liquidity buffer;
- conduct independent validation of liquidity stress tests; and
- establish and maintain a contingency funding plan that sets out the Covered Company's strategies for addressing liquidity needs for circumstances in which normal sources of funding may not be available.

In particular, each contingency funding plan would require:

- a quantitative assessment of future liquidity needs and funding sources;
- an event management process that sets out the procedures for managing liquidity during identified liquidity stress events;
- procedures for monitoring emerging liquidity stress events; and
- periodic testing of the components of the contingency funding plan to assess its reliability during liquidity stress events.

To enhance management of liquidity risk, the Proposed Rule also would require a Covered Company to establish and maintain limits on potential sources of liquidity risk, including three specified sources of liquidity risk:

- concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers;
- the amount of specified liabilities that mature within various time horizons; and
- off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.

Liquidity and collateral positions must be monitored on a daily and intra-day basis. The Proposed Rule would require a Covered Company to monitor liquidity risk related to collateral positions, liquidity risks across the enterprise and intraday liquidity positions. A Covered

Company would be required to establish and maintain procedures for monitoring assets it has pledged as collateral for an obligation or position and assets that are available to be pledged.

All procedures for managing liquidity risk also must be monitored and documented. To promote effective monitoring across the enterprise, the Proposed Rule would require a Covered Company to establish and maintain procedures for monitoring and controlling liquidity risk exposures and funding needs within and across significant legal entities, currencies and business lines. In addition, the Proposed Rule would require the Covered Company to maintain sufficient liquidity with respect to each significant legal entity in light of legal and regulatory restrictions on the transfer of liquidity between legal entities. The Proposed Rule would require a Covered Company to adequately document all material aspects of its liquidity risk management processes and its compliance with the requirements of the Proposed Rule, and submit such documentation to the risk committee.

Liquidity requirements imposed on an individual institution are not expected to be "one size fits all." Rather, the requirements of the Proposed Rule are designed to increase in stringency based on the systemic footprint of a company. For example, a Covered Company's capital structure, risk profile, complexity, activities, size and other appropriate risk related factors would be considered in: (i) setting the liquidity risk tolerance of the Covered Company; (ii) determining the amount of detail provided in cash flow projections; (iii) tailoring liquidity stress testing to the Covered Company; (iv) setting the size of the liquidity buffer; (v) formulating the contingency funding plan; and (vi) setting the size of the specific limits on potential sources of liquidity risk. In addition, the Federal Reserve would reserve its authority to require a Covered Company to be subject to additional or further enhanced prudential standards if it determines that compliance with the rule does not sufficiently mitigate the risks to U.S. financial stability posed by the failure or material financial distress of the Covered Company.

2. Future Proposal as to Quantitative Liquidity Measures

In addition to the enhanced liquidity risk management standards included in the Proposed Rule, the Federal Reserve and other U.S. federal banking agencies have been working with the BCBS over the past few years to develop quantitative liquidity requirements to increase the capacity of internationally active banking firms to absorb funding shocks relative to the liquidity risks they face. The BCBS approved two new liquidity rules as part of the Basel III reforms in December 2010:

- a Liquidity Coverage Ratio ("LCR"), which would require banks to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows over a 30-day time horizon under a supervisory stress scenario; and
- a Net Stable Funding Ratio ("NSFR"), which would require banks to enhance their liquidity risk resiliency out to one year.

These metrics are currently undergoing observation by the BCBS and may be modified depending on the results of that observation.

The Federal Reserve intends, in conjunction with other federal banking agencies, to implement these standards in the United States through one or more separate rulemakings. Through implementation of these standards in the United States, the Federal Reserve anticipates that the Basel III liquidity rules would then become a central component of the enhanced liquidity requirements for Covered Companies, or a subset of Covered Companies, in compliance with Dodd-Frank. Under the terms of Basel III, global banks are required to comply with the LCR by 2015 and with the NSFR by 2018.

## D. SINGLE-COUNTERPARTY EXPOSURE LIMITS

Section 165(e) of Dodd-Frank requires the Federal Reserve to prescribe, by regulation, standards that prohibit a Covered Company from having credit exposure to any unaffiliated company that exceeds 25% of the Covered Company's capital stock and surplus (or such lower threshold if necessary to mitigate risks to U.S. financial stability). As explained in the background material accompanying the Proposed Rule, the recent financial crisis highlighted how "[t]he effect of one large financial institution's failure or near collapse was amplified by the interconnectedness of large, systemically important firms" and "the degree to which they extended each other credit and served as over-the-counter counterparties to each other." In addition, the financial crisis exposed deficiencies in the existing U.S. supervisory approach to single-counterparty credit concentration limits, "which failed to limit the interconnectedness among and concentration of similar risks within large financial companies that contributed to a rapid escalation of the crisis."

The Proposed Rule introduces a two-tier single-counterparty credit limit: (i) a general limit on a Covered Company's aggregate net credit exposure to any single unaffiliated counterparty and (ii) a more stringent limit applicable to aggregate net credit exposures of the largest Covered Companies. Both limits would be measured in terms of a Covered Company's capital stock and surplus (defined as the Covered Company's total regulatory capital and the balance of its allowance for loan and lease losses not included in Tier 2 capital in the capital adequacy guidelines applicable to the Covered Company) and, importantly, apply on a consolidated basis.

### 1. General 25% Limit on Aggregate Net Credit Exposure for Covered Companies

A Covered Company, together with its subsidiaries, would be prohibited from having an aggregate net credit exposure to any unaffiliated counterparty, together with its subsidiaries, that exceeds 25% of the consolidated capital stock and surplus of the Covered Company.

### 2. 10% Limit on Aggregate Net Credit Exposures Between Major Covered Companies and Major Counterparties

The Proposed Rule also targets the mutual interconnectedness of financial companies that have a larger systemic footprint, with a stricter quantitative limit applying for credit exposures between so-called "Major Covered Companies" and "Major Counterparties." Specifically, a Major Covered Company, together with its subsidiaries, would be prohibited from having an aggregate net credit exposure to an unaffiliated Major Counterparty that exceeds 10% of the

Major Covered Company's consolidated capital stock and surplus. For this purpose, a Major Covered Company includes (i) a bank holding company that has $500 billion or more in total consolidated assets and (ii) any nonbank Covered Company. A Major Counterparty includes (i) any Major Covered Company (and all of its subsidiaries) and (ii) any foreign banking organization (and all of its subsidiaries) that has $500 billion or more in total consolidated assets.

3. Key Terms and Calculations

*(i) Subsidiaries*

The credit exposure limits under the Proposed Rule apply to both a Covered Company and its subsidiaries, on the one hand, and an unaffiliated counterparty and its subsidiaries, on the other hand. A "subsidiary" is a company that is directly or indirectly controlled by another company. For this purpose, a company controls another company if it (i) owns or controls 25% or more of a class of a company's voting securities, (ii) owns or controls 25% or more of a company's total equity or (iii) consolidates the company for financial reporting purposes. Significantly, this standard of control would exclude the more subjective "controlling influence" test contained in the Bank Holding Company Act and the Federal Reserve's Regulation Y.

Under the Proposed Rule, a fund or vehicle that is sponsored or advised by a Covered Company would not be considered a subsidiary of the Covered Company (and, thus, exposures to such fund or vehicle would not be aggregated with those of the Covered Company) unless it falls within the voting/equity ownership or financial reporting "control" tests above. The Federal Reserve has requested comment on whether the exclusion of a non-controlled sponsored or advised fund or vehicle is appropriate, particularly given the support that many money market fund sponsors, including banking organizations, gave to their funds during the financial crisis "in order to enable those funds to meet investor redemption requests without having to sell assets into then-fragile and illiquid markets."

*(ii) Counterparties*

The Proposed Rule would establish limits on the credit exposure of a Covered Company to a single unaffiliated "counterparty," which is defined to include:

- with respect to a natural person, the person and members of the person's immediate family, collectively;
- with respect to a company, the company and all of its subsidiaries, collectively;
- with respect to the United States, the United States and all of its agencies and instrumentalities (excluding states and their political subdivisions), collectively;
- with respect a U.S. state, the state and all of its agencies, instrumentalities, and political subdivisions (including any municipalities), collectively; and

- with respect to a foreign sovereign entity, the foreign sovereign entity and all of its agencies, instrumentalities, and political subdivisions, collectively.

Significantly, the Federal Reserve included foreign sovereign entities in the counterparty definition because it believes that credit exposures of a Covered Company to such governmental entities create risks that are comparable to those created by large exposures to other types of entities, such as financial firms. With regard to the U.S. government, as discussed below, the Proposed Rule specifically exempts certain exposures to the U.S. government from the limits.

*(iii) Credit Transactions*

Consistent with the definition of "credit exposure" in Section 165(e)(3) of Dodd-Frank, the limits under the Proposed Rule apply broadly to the following "credit transactions" with a counterparty:

- any extension of credit, including loans, deposits and lines of credit, but excluding advised or other uncommitted lines of credit;
- any repurchase or reverse purchase agreement;
- any securities lending or securities borrowing transaction;
- any guarantee, acceptance or letter of credit (including any confirmed letter of credit or standby letter of credit) issued on behalf of the counterparty;
- any purchase of, or investment in, securities issued by the counterparty;
- any credit exposure to the counterparty in connection with a derivative transaction with the counterparty;
- any credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction between the Covered Company and a third party where the reference asset is an obligation or equity security of the counterparty; and
- any transaction that is the functional equivalent of the transactions listed above or any similar transaction that the Federal Reserve determines to be a credit transaction.

*(iv) Calculation of Credit Exposures*

Generally, a Covered Company will first calculate its "gross credit exposure" and then calculate its "net credit exposure" after taking into account and adjusting for certain credit risk mitigants such as netting agreements for certain types of transactions, most forms of collateral (subject to haircuts), guarantees and other forms of credit protection.

(A) Calculation of Gross Credit Exposure

The Proposed Rule outlines how the gross credit exposure of a Covered Company to a counterparty would be calculated with respect to the following types of credit transactions:

| Type of Credit Transaction | Gross Credit Exposure |
|---|---|
| Loans and leases to a counterparty | The amount owed by the counterparty to the Covered Company |
| Debt securities issued by the counterparty | The greater of the amortized purchase price or market value, for trading and available for sale securities, and the amortized purchase price, for securities held to maturity |
| Equity securities issued by the counterparty | The greater of the purchase price or market value |
| Repurchase agreements | The market value of the securities transferred by the Covered Company to the counterparty plus such market value amount multiplied by the applicable collateral haircut to the securities transferred by the Covered Company to the counterparty |
| Reverse repurchase agreements | The amount of cash transferred by the Covered Company to the counterparty |
| Securities borrowing transactions | The amount of cash collateral plus the market value of securities collateral transferred by the Covered Company to the counterparty |
| Securities lending transactions | The market value of securities lent by the Covered Company to the counterparty plus such market value amount multiplied by the applicable collateral haircut to the securities lent by the Covered Company to the counterparty |
| Committed credit lines to a counterparty | The face amount of the credit line |
| Guarantees and letters of credit issued on behalf of a counterparty | The lesser of the face amount or the maximum potential loss to the Covered Company on the transaction |
| Derivative transactions that are not subject to a qualifying master netting agreement | The sum of (i) the current exposure of the derivatives contract equal to the greater of the mark-to-market value of the derivative contract or zero and (ii) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the derivative contract by the appropriate conversion factor |
| Derivative transactions that are subject to a qualifying master netting agreement | The exposure at default amount calculated under the Federal Reserve's existing methodology (*see* 12 C.F.R. Part 225, App. G, § 32(g)(6)) |
| Credit or equity derivative transactions with a third party where the Covered Company is the protection provider and the reference assets is an obligation or equity security of the counterparty | The lesser of the face amount of the transaction or the maximum potential loss to the Covered Company on the transaction |

With respect to derivative transactions, a "qualifying master netting agreement" is defined in the Proposed Rule as a legally enforceable bilateral agreement such that: (i) the agreement creates a legal obligation for all individual transactions covered by the agreement upon an event of default (including bankruptcy, insolvency, or similar proceeding of the counterparty); (ii) the agreement provides that the Covered Company has the right to accelerate, terminate and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, and that, in such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdiction; (iii) the Covered Company has conducted sufficient legal review to conclude that the agreement meets the requirements in the immediately preceding clause and that in the event of a legal challenge the relevant court and administrative authorities would find the agreement to be valid, binding and enforceable under the law of the relevant jurisdiction; (iv) the Covered Company establishes and maintains procedures to monitor possible changes in relevant law and to ensure the agreement continues to satisfy the requirements of this definition; and (v) the agreement does not contain a walk-away clause (*i.e.*, a clause that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter is a net creditor under the agreement).

(B) Calculation of Net Credit Exposure

In calculating net credit exposure, the Proposed Rule would permit exposures from repurchase and reverse repurchase transactions and securities lending and borrowing transactions that are subject to a bilateral netting agreement (as defined above) with the relevant counterparty to be calculated on a net basis under such agreement.

Importantly, the Proposed Rule provides that gross credit exposure amounts can be converted into net credit exposure amounts by taking into account eligible collateral, unused credit lines, eligible guarantees, eligible credit and equity derivatives and other eligible hedges. If a Covered Party has eligible collateral, then it would have the choice to reduce its gross credit exposure to a counterparty by the adjusted market value of that collateral, subject to the applicable regulatory haircut for that type of collateral and to other limitations. If a Covered Company chooses to reduce its gross credit exposure by the adjusted market value of eligible collateral, however, it would be required to include the adjusted market value of the eligible collateral when calculating its gross credit exposure to the issuer of the collateral (in effect, the Covered Company would shift its credit exposure from the original counterparty to the issuer of the eligible collateral). The term “eligible collateral” means collateral in which the Covered Company has a perfected, first priority security interest (or the legal equivalent, if outside the United States), with the exception of cash on deposit and notwithstanding the prior security interest of any custodial agent, and which is in the form of (i) cash on deposit with the Covered Company (including cash held for the Covered Company by a third party custodian or trustee), (ii) debt securities (other than mortgage- or asset-backed securities) that are bank eligible investments, (iii) equity securities that are publicly traded or (iv) convertible bonds that are publicly traded. Because tracking the market movements of a diverse pool of collateral can be operationally burdensome, Covered Companies would not be required to reduce their credit exposure in respect of any eligible collateral based on changes in market prices.

Covered Companies would also be able, but not required, to reduce their gross credit exposure by the amount of certain unused extensions of credit, provided generally that the Covered Company does not have a legal obligation to advance additional funds under the relevant extension of credit and that the relevant credit contract specifies that any unused portion of the credit extension be fully secured by certain high quality collateral, such as cash and U.S. government obligations.

In contrast to eligible collateral and unused credit lines, Covered Companies that have "eligible guarantees," "eligible credit and equity derivatives" or "other eligible hedges," each as defined in the Proposed Rule, would be required to reduce their gross credit exposures to the relevant counterparties by the amount of the eligible guarantees, the notional amount of such eligible credit and equity derivatives or the face amount of a short sale of the counterparty's debt or equity securities, as applicable.

4. Attribution Rule

Consistent with Section 165(e)(4) of Dodd-Frank, the Proposed Rule provides that a Covered Company must treat a transaction with any person as a credit exposure to a counterparty to the extent the proceeds of the transaction are used for the benefit of, or transferred to, that counterparty. Because an overly broad application of this so-called attribution rule "would lead to inappropriate results and would create a daunting tracking exercise" for Covered Companies, the Federal Reserve is expected to limit application of the attribution rule to those situations where it is necessary to prevent evasion of the limits.

5. Effectiveness; Compliance

Initially, any company that is a Covered Company on the effective date or that became a Covered Company before September 30, 2012 will be subject to the credit exposure limits beginning on October 1, 2013. Once the Proposed Rule becomes effective, a company that becomes a Covered Company will have until the first day of the fifth quarter following the date on which it became a Covered Company to comply with the limits.

Covered Companies will need to comply with the limits on a daily basis, measured as of the end of each business day. Covered Companies will also need to submit monthly compliance reports. In the event of noncompliance, a Covered Company will have a 90-day cure period during which time it will not be subject to enforcement actions if it uses reasonable efforts to return to compliance. During the 90-day cure period, a Covered Company is prohibited from engaging in any additional credit transactions with the counterparty, unless the Federal Reserve determines such transactions are "necessary or appropriate to preserve the safety and soundness" of the Covered Company or U.S. financial stability. In granting approval for such a special temporary credit exposure limit, the Federal Reserve will consider the extent to which noncompliance with respect to a counterparty was due to (i) a decrease in the Covered Company's capital stock and surplus, (ii) the merger of the Covered Company with another Covered Company, (iii) the merger of two unaffiliated counterparties, or (iii) any other circumstance the Federal Reserve determines is appropriate.

6. Exemptions

Certain categories of credit transactions are exempt from the credit exposure limits, including claims that are directly and fully guaranteed as to principal and interest by the United States and its agencies, Fannie Mae and Freddie Mac (only while operating under U.S. conservatorship), and any additional obligations issued by a U.S. government sponsored entity as determined by the Federal Reserve.

7. Relationship to Other Exposure Limits

The Proposed Rule makes clear that the single-counterparty exposure limits for Covered Companies are similar to, but also broader than, existing limits that have applied only at the bank level of banking organizations. Traditionally, depository institutions (i) are limited to 10% of their capital stock and surplus when purchasing investment securities from any one obligor; and (ii) face a total loan-to-one borrower limit that cannot exceed 15% of their capital stock or surplus (or 25% if the amount that exceeds the general limit is fully secured by readily marketable collateral). These investment securities and lending limits are separate and distinct from the single-counterparty exposure limits and, accordingly, are unaffected by the Proposed Rule.

## E. RISK MANAGEMENT AND RISK COMMITTEE REQUIREMENTS

Section 165(b) of Dodd-Frank requires the Federal Reserve to establish overall risk management requirements for Covered Companies, while Section 165(h) requires the Federal Reserve to issue regulations requiring publicly traded (i) nonbank Covered Companies and (ii) bank holding companies with total consolidated assets of $10 billion or more to establish risk committees. Dodd-Frank also authorizes, but does not require, the Federal Reserve to impose the risk committee requirement on all publicly traded bank holding companies, regardless of their asset size. Under Dodd-Frank, a risk committee would be responsible for the oversight of risk management practices on an enterprise-wide basis.

Significantly, the Proposed Rule goes farther than what is required by Dodd-Frank in that it would extend the risk committee requirement to all Covered Companies, regardless of whether they are publicly traded. Bank holding companies that have between $10 billion and $50 billion in total consolidated assets would not be subject to the risk committee requirement under the Proposed Rule if they are not designated as Covered Companies and are not publicly traded.

In the background material accompanying the Proposed Rule, the Federal Reserve emphasizes that the risk committee and overall risk management requirements would supplement, and not replace, existing risk management guidance and supervisory expectations, including under the Federal Reserve's Supervision and Regulation Letter SR 08-8.

1. Risk Committee Requirements

Under the Proposed Rule, each Covered Company (publicly traded or not) and each publicly traded bank holding company with $10 billion or more in total consolidated assets would be required to establish and maintain an enterprise-wide risk committee consisting of members of its board of directors.

Such a risk committee would be required to:

- have a formal, written charter, approved by the company's board of directors;
- have at least one member with "risk management expertise" that is commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk related factors;
- be chaired by an independent director[4]; and
- meet regularly and as needed, and fully document and maintain records of such proceedings, including risk management decisions.

As for responsibilities, the Proposed Rule would require each committee to oversee the operation of, on an enterprise-wide basis, an appropriate risk management framework that includes:

- risk limitations appropriate to each business line of the company;
- appropriate policies and procedures relating to risk management governance, risk management practices and risk control infrastructure for the enterprise as a whole;
- processes and systems for indentifying and reporting risks and risk-management deficiencies, including emerging risks, on an enterprise-wide basis;
- monitoring of compliance with the company's risk limit structure and policies and procedures relating to risk management governance, practices and risk controls across the enterprise;
- effective and timely implementation of corrective actions to address management deficiencies;
- specification of management and employees' authority and independence to carry out risk management responsibilities; and
- integration of risk management and control objectives in management goals and the company's compensation structure.

2. <u>Additional Risk Management Requirements for Covered Companies</u>

The risk committees of Covered Companies would have to satisfy additional requirements. Specifically, a Covered Company's risk committee would have to be a stand-alone committee,

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[4] For publicly traded companies, the Federal Reserve will generally not consider a director to be independent unless the company indicates in its securities filings, pursuant to Regulation S-K of the Securities and Exchange Commission, that the director satisfies the applicable independence requirements of the national securities exchange on which the company's securities are listed. In the case of a director of a non-publicly traded company, the Federal Reserve will expect, among other things, that the company demonstrate that such director would qualify as an independent director under the listing standards of a national securities exchange if the company were publicly traded on such an exchange.

in that it could not be housed within another committee or be part of a joint committee, and it would have to report directly to the Covered Company's board of directors and receive and review regular reports from the chief risk officer ("CRO"), who a Covered Company would be required to employ to oversee risk management practices on an enterprise-wide basis. The CRO would have to report directly to both the risk committee and the chief executive officer and be "appropriately compensated and incentivized to provide an objective assessment" of the risks taken by the Covered Company. The CRO must also have risk management expertise that is commensurate with the Covered Company's structure, risk profile, complexity, activities, size and other risk-related factors. The Federal Reserve is soliciting comments on whether the Proposed Rule should specify any minimum qualifications, such as educational attainment and professional experience, for the CRO of a Covered Company.

## F. STRESS TESTING REQUIREMENTS

During the height of the crisis, the Federal Reserve began stress testing the capital adequacy of large, complex bank holding companies as a forward-looking exercise designed to estimate losses, revenues, regulatory capital ratios, and reserve needs under various macroeconomic scenarios. These stress tests provided valuable information to market participants and had an overall stabilizing effect. Dodd-Frank directs the Federal Reserve to implement rules requiring the Federal Reserve, in coordination with the appropriate primary federal financial regulatory agencies and the Federal Insurance Office, to conduct an annual supervisory stress tests of Covered Companies and to publish a summary of those results. In addition, Dodd-Frank requires each Covered Company to conduct its own semi-annual stress tests and any state member bank, bank holding company or savings and loan holding company with more than $10 billion in total consolidated assets (that is not a Covered Company) to conduct its own annual stress tests (company-run stress tests). Covered Companies must also publish a summary of the results of the company-run stress tests.

The Proposed Rule would implement these statutory provisions by requiring the Federal Reserve to conduct annual supervisory stress tests of Covered Companies under baseline, adverse and severely adverse scenarios, as well as by requiring companies that are subject to company-run stress test requirements to conduct their own capital adequacy stress tests on an annual or semi-annual basis, as applicable. Under the Proposed Rule, the Federal Reserve would publicly disclose information on the company-specific results of the supervisory stress tests.

## G. DEBT-TO-EQUITY LIMIT FOR CERTAIN COVERED COMPANIES

Under Section 165(j) of Dodd-Frank, if the FSOC determines that a Covered Company (i) poses a "grave threat" to U.S. financial stability and (ii) that the imposition of a leverage limitation is "necessary to mitigate" that threat, then the Federal Reserve must require the company to maintain a debt-to-equity ratio of no more than 15-to-1. Absent these two findings by the FSOC, the leverage limitation does not apply automatically.

The Proposed Rule defines "debt" and "equity" as having the same meaning as "total liabilities" and "total equity capital," respectively, as calculated in a company's reports of financial condition (*i.e.*, in the case of a bank holding company, on the Federal Reserve's Form FR Y-9C). The 15-to-1 debt-to-equity ratio would be calculated as the ratio of total liabilities to total equity capital minus goodwill.

A Covered Company that is subject to a "grave threat" determination by the FSOC will receive written notice from the FSOC.[5] After receiving such notice, the Covered Company will have 180 calendar days to come into compliance with the prescribed debt-to-equity ratio requirement, although it may seek up to two extensions of 90 days each. The debt-to-equity ratio requirement would remain in effect until the FSOC determines that a particular Covered Company no longer poses a grave threat to U.S. financial stability and that the imposition of the leverage limitation is no longer necessary.

Although the Proposed Rule does not outline a specific set of actions that must be taken in order to comply with the debt-to-equity ratio requirement, the Federal Reserve would expect a Covered Company to comply in a manner that is consistent with its "safe and sound operation and preservation of financial stability." As an example of what is expected in this regard, the Federal Reserve would look to whether a Covered Company has made a "good faith effort to increase equity capital through limits on distributions, share offerings, or other capital raising efforts prior to liquidating margined assets in order to achieve the required ratio."

As with the liquidity and risk management requirements discussed above, the leverage limitation can be applied to U.S. bank holding company subsidiaries of foreign banking organizations that are currently relying on the Federal Reserve's Supervision and Regulation Letter SR 01-01.

## H. EARLY REMEDIATION REQUIREMENTS

To minimize the probability that a Covered Company will become insolvent and the potential harm of such insolvency to U.S. financial stability, Section 166 of Dodd-Frank requires the Federal Reserve to issue regulations providing for the early remediation of financial distress of Covered Companies. The regulations must define measures of the financial condition of the company (including regulatory capital, liquidity measures and other forward-looking indicators) and establish requirements that increase in stringency as the financial condition of the company declines. The Proposed Rule establishes this early remediation framework, setting forth a matrix of five remedial triggering events, including several forward-looking triggers, and four levels of remediation actions that Covered Companies are required to take when the relevant triggering event occurs.

### 1. Early Remediation Requirements

The Proposed Rule lays out four levels of remediation requirements and several forward-looking triggers designed to identify emerging or potential issues before they develop into

[5] The background information accompanying the Proposed Rule provides that the notice would come from the Federal Reserve. *See* 77 Fed. Reg. 594, 633 (Jan. 5, 2012). However, the Proposed Rule itself states that such notice would come from the FSOC.

larger problems. Most of the remediation actions under each level are non-discretionary and apply automatically once a triggering event subjects a Covered Company to that level.

*(i) Level 1 – Heightened Supervisory Review*

Under Level 1 remediation, the Federal Reserve would conduct, within 30 days of a Level 1 triggering event, a targeted supervisory review of the Covered Company to determine whether a Covered Company is experiencing financial distress or material risk management weakness, such that further decline of the Covered Company is probable and that the Covered Company should be subject to the next level of remediation (initial remediation).

*(ii) Level 2 – Initial Remediation*

Under Level 2 remediation, a Covered Company would be subject to, among other things: restrictions on capital distributions and asset growth; a restriction on acquiring any controlling interest in any company (including an insured depository institution), establishing or acquiring any office or other place of business or engaging in any new business line, in each case, without the Federal Reserve's prior approval; a requirement to enter into a non-public memorandum of understanding or other acceptable enforcement action; and additional limitations or conditions on the conduct or activities of the Covered Company (or any of its affiliates) as the Federal Reserve deems appropriate and consistent with Title I of Dodd-Frank.

*(iii) Level 3 – Recovery*

Under Level 3 remediation, a Covered Company would be subject to, among other things: flat prohibitions on capital distributions, asset growth, acquiring any interest in any company (including a depository institution), establishing or acquiring any office or other place of business or engaging in any new business line; a requirement to raise additional capital; and a limitation on executive compensation. In addition, the Federal Reserve could require the Covered Company to (i) conduct a new election of the institution's board of directors, (ii) dismiss senior executive officers who had held office for more than 180 days prior to the Covered Company's notification that it is subject to Level 3 remediation or (iii) employ qualified senior executive officers approved by the Federal Reserve. The Federal Reserve may also place restrictions on the Covered Company engaging in transactions with its affiliates.

*(iv) Level 4 – Resolution Assessment*

Under Level 4 remediation, the Federal Reserve must consider whether a Covered Company poses a risk to the stability of the U.S. financial system. If the Federal Reserve determines, based on the Covered Company's financial decline and the risk posed to U.S. financial stability, that the Covered Company should be placed into receivership under the orderly liquidation authority provided for in Title II of Dodd-Frank, the Federal Reserve must make a written recommendation to the Treasury Department and the FDIC to that effect.

2. Early Remediation Triggering Events

A number of triggering events will determine whether a Covered Company falls within one of the four levels of remediation requirements. These events would be based on the Federal Reserve's existing definitions of minimum risk-based capital and leverage ratios, the results of supervisory stress tests under the Proposed Rule, weaknesses in complying with enhanced risk management and liquidity standards and other market indicators.

Once the Federal Reserve ascertains that a remediation event under the Proposed Rule has occurred with respect to a Covered Company, it must notify the Covered Company of the event and the applicable remediation action to be taken. Also, a Covered Company would be required to notify the Federal Reserve if it becomes aware of a triggering event or a change in the remediation level to which it is subject.

*(i) Risk-Based Capital and Leverage*

While a change in regulatory capital levels may be a lagging, rather than forward-looking, indicator of distress, the Federal Reserve intends to differentiate the early remediation regime from the existing prompt corrective action regime. In this regard, the Federal Reserve would impose non-discretionary restrictions on growth and capital distributions by a Covered Company if its capital levels fall below the "well capitalized" threshold (in contrast, similar actions are not imposed under the prompt corrective action regime until a depository institution becomes less than "adequately capitalized"). In addition, Level 1 remediation would be triggered if the Federal Reserve determines that a Covered Company's capital structure or planning process is not commensurate with the level and nature of the risks to which the company is exposed, even if the company's capital ratios exceed the minimum levels that would trigger Level 2 remediation. Levels 2, 3 and 4 remediation actions would be triggered if any of the Covered Company's capital ratios fall below the minimum required level in the table below. Level 3 remediation would also be triggered if any of the capital ratios remain at the Level 2 levels for two consecutive quarters.

| | Level 2 | Level 3 | Level 4 |
|---|---|---|---|
| Total risk-based capital ratio | < 10.0% and ≥ 8.0% | < 8.0% and ≥ 6.0% | < 6.0% |
| Tier 1 risk-based capital ratio | < 6.0% and ≥ 4.0% | < 4.0% and ≥ 3.0% | < 3.0% |
| Tier 1 leverage ratio | < 5.0% and ≥ 4.0% | < 4.0% and ≥ 3.0% | < 3.0% |

The Federal Reserve intends to make changes to the regulatory capital triggers to conform to the new capital requirements to be implemented under Basel III.

*(ii) Stress Tests*

To integrate the enhanced prudential standards under the Proposed Rule with the early remediation regime, the Federal Reserve proposes to use the results of the supervisory stress test under the "severely adverse scenario" as a trigger for early remediation action. Level 1 remediation would be triggered when a Covered Company is not in compliance with any of the Federal Reserve's capital plan and stress test requirements. Levels 2 and 3 would be triggered depending on the level of a Covered Company's Tier 1 common risk-based capital ratio under the severely adverse scenario, with Level 2 remediation required when the ratio is less than 5.0% and greater than or equal to 3.0% and Level 3 remediation required when the ratio is less than 3.0%.

*(iii) Risk Management/Liquidity*

Under the Proposed Rule, a Covered Company's failure to comply with the enhanced risk management provisions or liquidity risk management requirements of the Proposed Rule would trigger Level 1, 2 or 3 remediation depending on the severity of noncompliance. The standards for determining the severity of noncompliance are as follows: "manifested signs of weakness" for Level 1, demonstration of "multiple deficiencies" for Level 2 and "substantial noncompliance" for Level 3. The Federal Reserve has not provided any guidance as to how these standards differ from each other.

*(iv) Market Indicators*

The Federal Reserve also proposes to use various market indicators designed to capture both emerging idiosyncratic and systemic risk across Covered Companies. Rather than setting forth such indicators in the Proposed Rule, the Federal Reserve proposes to publish for comments annually (or less frequently as deemed appropriate) the market-based triggers and thresholds. For now, Level 1 remediation would be required if the Federal Reserve determines that any single market indicator has exceeded the market indicator threshold with respect to the Covered Company for the applicable breach period.

The Federal Reserve has proposed an initial list of market-based indictors, including various equity-based and debt-based indicators.

- Equity-Based Indicators—The proposed equity-based indicators include: (i) an "expected default frequency," which measures the expected probability of default in the next 365 days based on a model developed by Moody's; (ii) a "marginal expected shortfall," which would look at the expected loss in a company's equity based on its stock price and volatility; (iii) a "market equity ratio," which is the ratio of market value of equity to market value of equity plus book value of debt; and (iv) "option-implied volatility," which would use a standard option pricing model.

- Debt-Based Indicators—The proposed debt-based indicators would be based on credit default swaps (CDS) and subordinated debt (bond) spreads.

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For more information regarding the Proposed Rule or how comments may be submitted to the Federal Reserve, please contact a member of Simpson Thacher's Financial Institutions Group.

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