SIMPSON THACHER MEMORANDUM

Federal Reserve Issues Final Regulations on Enhanced Prudential Standards for Foreign Banking Organizations

February 25, 2014

On February 18, 2014, the Federal Reserve Board approved final rules that apply enhanced prudential standards to foreign banking organizations ("FBOs") exceeding certain asset thresholds. The final rules implement a number of new requirements, including enhanced risk-based capital and leverage requirements, liquidity requirements, risk management and stress testing requirements, a requirement to establish a U.S. intermediate holding company and a U.S. risk committee for certain FBOs, and a requirement to comply with a debt-to-equity limit for FBOs that have been determined to pose a grave threat to the financial stability of the United States. The final rules, which implement Section 165 of the Dodd-Frank Act and follow proposed rules issued in December 2012, constitute a significant overhaul to existing foreign bank supervision in the United States.

The final rules include a number of significant changes from the proposed rules, including:

- *Higher Threshold for the U.S. Intermediate Holding Company Requirement*—An FBO with $50 billion or more in U.S. non-branch assets (*i.e.*, U.S. assets excluding assets of U.S. branches and agencies, which are not separate legal entities from the FBO parent) is required to establish a U.S. top-tier intermediate holding company ("IHC") to own all U.S. bank and nonbank subsidiaries, with limited exclusions. Under the proposed rules, an FBO with only $10 billion or more in U.S. non-branch assets would have been subject to the IHC requirement.
- *More Time to Comply with the IHC and Leverage Requirements*—The final rules delay the compliance date of the IHC requirement by one year. An FBO meeting the $50 billion U.S. non-branch asset threshold as of June 30, 2015 must substantially comply with the IHC requirement by July 1, 2016, and fully comply by July 1, 2017. An FBO that crosses the $50 billion threshold subsequent to June 30, 2015 has two years to comply with the requirement. In addition, leverage requirements for IHCs are delayed until January 1, 2018.
- *New Implementation Plan Requirement*—An FBO meeting the $50 billion U.S. non-branch asset threshold as of June 30, 2014 must submit a detailed implementation plan to the Federal Reserve by January 1, 2015 outlining the FBO's proposed process to comply with the IHC requirement. If an FBO seeks to exclude a particular subsidiary from its IHC, then the plan must also contain required information about that subsidiary, as well as the reasons it should be excluded.
- *IHCs Not Subject to Advanced Approaches Risk-Based Capital Rules*—While the proposed rules would have required the largest IHCs to comply with the advanced approaches

risk-based capital rules under Subpart E of Regulation Q,[1] the final rules exempt IHCs from complying with the advanced approaches methodologies regardless of size, although certain related requirements (such as countercyclical buffers and inclusion of accumulated other comprehensive income in capital) will apply to IHCs that would otherwise satisfy the threshold requirements for application of those rules.

- *Requirement for IHC Risk Committee*—Under the proposed rules, the required U.S. risk committee for the U.S. operations of certain FBOs with IHCs could have been located at the FBO parent level, including as part of the FBO's board. The final rules retain that provision, but require that in all cases the IHC itself have its own risk committee (which can also be responsible for all U.S. operations, in which case there would no need for an FBO parent-level U.S. risk committee).

The final rules do not implement Dodd-Frank Act requirements relating to single-counterparty credit limits or early remediation requirements, which were included in the proposed rules but will be finalized at a later date. The final rules also do not implement prudential standards for nonbank financial companies (whether foreign or domestic) designated as systemically important by the Financial Stability Oversight Council ("FSOC") and subject to supervision by the Federal Reserve.[2]

A. SCOPE OF APPLICATION

The final rules are structured with tiered levels of regulation depending upon the size of an FBO's global and U.S. consolidated assets, with the most comprehensive U.S. regulation applied to those FBOs with combined U.S. assets of more than $50 billion. As detailed in the table below, some aspects of the final rules apply to FBOs with more than $10 billion in total global consolidated assets, additional aspects apply to FBOs with total global consolidated assets of $50 billion or more, and the most stringent aspects apply to FBOs with combined U.S. assets of $50 billion or more.

---

[1] New Regulation Q (12 C.F.R. Part 217) sets forth the Federal Reserve's revised capital framework, as adopted in July 2013. For a summary of the revised capital framework, please see our memorandum titled, "Federal Reserve Adopts Final U.S. Bank Capital Standards Under Basel III," dated July 8, 2013, *available at* http://www.stblaw.com/about-us/news/details?id=55abe6b4-d81a-4e3c-9cb4-7fd02835c9eb.

[2] The Federal Reserve will apply enhanced prudential standards to nonbank financial companies supervised by the Federal Reserve through a subsequently issued order or rule following an evaluation of the business model, capital structure, and risk profile of each designated nonbank financial company. At this time, no foreign nonbank financial companies have been designated for Federal Reserve supervision.

Scope of Application for FBOs

Global Assets	U.S. Assets	Requirements
> $10 Billion and < $50 Billion	**N/A**	Must: • Have a U.S. risk committee (if publicly traded) • Meet home country capital stress test requirements that are broadly consistent with U.S. requirements
≥ $50 Billion	**< $50 Billion**	All of the above, plus: • Must have a U.S. risk committee (even if not publicly traded) • Must meet home country capital standards that are consistent with Basel standards • Must conduct annual liquidity stress tests that are consistent with Basel principles and report results for either the FBO or its U.S. operations to the Federal Reserve • Subject to debt-to-equity limits (upon "grave threat" determination)

≥ $50 Billion	**≥ $50 Billion**	All of the above, plus:
		• Must have a U.S. chief risk officer
		• Subject to monthly tailored liquidity stress tests, enhanced liquidity risk management standards and U.S. in-country liquidity buffer requirements
		• Must annually report the results of capital stress tests to Federal Reserve, and must report the results of monthly liquidity stress tests to the Federal Reserve in a timely manner
		• Subject to IHC requirements if U.S. non-branch assets equal or exceed $50 billion, including:
		  o Capital adequacy and leverage standards under standardized approach of Regulation Q
		  o Capital plan rule (12 C.F.R. § 225.8) and all capital stress test requirements (so-called "DFAST" rules) as if IHC were a U.S. bank holding company

B. TIMING AND EFFECTIVENESS

Generally, the effective date of the final rules is June 1, 2014. However, FBOs have until July 1, 2016 or in some cases later to comply with the most significant requirements.

- *IHC Requirement*—By July 1, 2016, an FBO with U.S. non-branch assets of $50 billion or more as of June 30, 2015 must establish an IHC and transfer to the IHC its entire ownership interest in (i) any U.S. bank holding company subsidiary, (ii) any depository institution subsidiary, and (iii) U.S. subsidiaries holding at least 90% of the FBO's U.S. non-branch assets not owned by such subsidiary bank holding companies or depository institutions. By July 1, 2017, the FBO's IHC must hold any remaining U.S. subsidiaries of the FBO (subject to very limited exceptions). If an FBO crosses the $50 billion threshold subsequent to June 30, 2015, it will have two years to comply with the IHC requirement.

An FBO that meets the $50 billion threshold by June 30, 2014 must submit an implementation plan to the Federal Reserve by January 1, 2015.

- *Risk Management Requirements*—An FBO that has met or exceeded specified asset thresholds as of June 30, 2015, and an IHC required to be formed by July 1, 2016, must comply with the risk management requirements beginning July 1, 2016.

- *Capital, Leverage and Liquidity Requirements*—An FBO with consolidated assets of $50 billion or more as of June 30, 2015 must comply with the capital, leverage and liquidity requirements beginning July 1, 2016. An IHC required to be formed by July 1, 2016 must comply with the risk-based capital, capital plan and liquidity requirements beginning July 1, 2016 and the leverage requirements beginning January 1, 2018, provided that any subsidiary bank holding companies or insured depository institutions controlled by the FBO immediately prior to the establishment of the IHC or acquired by the FBO after establishment of the IHC must comply with existing applicable risk-based capital and leverage requirements until December 31, 2017.

- *Stress Testing Requirements*—An FBO that has met or exceeded specified asset thresholds as of June 30, 2015 must comply with applicable capital or liquidity stress testing requirements beginning July 1, 2016. An IHC required to be formed by July 1, 2016 must comply with capital and liquidity stress testing requirements beginning October 1, 2017, provided that any subsidiary bank holding companies or insured depository institutions controlled by the FBO prior to the establishment of the IHC or acquired by the FBO after establishment of the IHC must comply with existing capital and liquidity stress test requirements until September 30, 2017.

C. U.S. INTERMEDIATE HOLDING COMPANY REQUIREMENT

A key feature of the final rules is the requirement that an FBO establish an IHC if it has $50 billion or more in combined U.S. assets (excluding assets of its U.S. branches and agencies). An FBO meeting this threshold must transfer assets to its IHC by the effective dates described in Section B above. After-the-fact notice must be provided to the Federal Reserve within 30 days of establishing the IHC.

1. *Organizational and Structural Considerations*

An IHC must be organized under U.S. federal or state law (in response to comments, the Federal Reserve indicated in the preamble that the IHC is not permitted to be a foreign legal entity), although the final rules do not require any particular corporate form (*e.g.*, corporation, limited liability company or partnership). Also, there is no requirement that an IHC be wholly-owned by its FBO parent or any stated requirement that its directors or officers be U.S. persons or based in the United States.

Structurally, the IHC requirement is significant because it requires FBOs—many of which do not have a U.S. holding company—to have a single top-tier U.S. entity over their U.S. bank and nonbank subsidiaries. An FBO must hold all of its interests in any U.S. subsidiary exclusively

through the IHC, except: U.S. branches and agencies, so-called "Section 2(h)(2)" companies, and subsidiaries of U.S. branches and agencies acquired or formed to hold assets acquired in the ordinary course of business and for the sole purpose of securing or collecting debts previously contracted in good faith by that branch or agency. There are no exclusions for subsidiaries that engage in nonfinancial activities or for investment funds or subsidiaries held as merchant banking investments. Importantly, for purposes of the IHC requirement, the term "subsidiary" is defined by reference to Section 3 of the Federal Deposit Insurance Act, which includes any company that is controlled by the FBO (using the broad concept of "control" under the Bank Holding Company Act) and any service corporation owned in whole or in part by an insured depository institution. As a result, a subsidiary includes any company for which the FBO directly or indirectly: (i) owns, controls, or has the power to vote 25% or more of any class of voting securities; (ii) controls in any manner the election of a majority of its directors; or (iii) exercises a controlling influence over its management or policies.

2. *Potential Exemptive Relief*

The Federal Reserve retains discretion to allow an FBO, upon written request, to hold its interests in U.S. subsidiaries within alternative structures or through multiple IHCs or to not transfer its interests in certain subsidiaries to its IHC. The Federal Reserve will consider granting exemptions from the single IHC requirement if applicable home country law would prohibit the FBO from controlling its U.S. subsidiaries through a single IHC or where the activities, scope of operations or structure of the FBO's U.S. subsidiaries or similar considerations warrant consideration of alternative structures, such as where an FBO controls multiple lower-tier FBOs that have separate U.S. operations. In cases where the Federal Reserve exempts any U.S. subsidiaries from transfer to an IHC, it has the authority to impose conditions in connection with such relief, and indicated in the preamble to the final rules that it expects to require passivity commitments or other supervisory agreements to limit the exposure of the IHC to such subsidiaries.

3. *Implementation Plan*

An FBO meeting the $50 billion U.S. non-branch asset threshold as of June 30, 2014 will need to submit an implementation plan to the Federal Reserve by January 1, 2015 that addresses mandatory elements, including: (i) a list of all U.S. subsidiaries controlled by the FBO setting forth the ownership interest in each subsidiary and an organizational chart showing the ownership hierarchy; (ii) for each U.S. subsidiary for which the FBO expects to request an exemption from the requirement to transfer the subsidiary to the IHC, the name, asset size, and a description of the reasons why an exemption should be granted; (iii) a projected timeline for transfer and quarterly pro forma financial statements for the IHC, including regulatory capital ratios, for the period from December 31, 2015 to January 1, 2018; and (iv) descriptions of the risk management practices and liquidity stress testing practices of the U.S. operations of the FBO and how the FBO and IHC will come into compliance with the risk management and stress testing requirements of the final rules. For any FBO that meets or exceeds the $50 billion threshold after June 30, 2014, the Federal Reserve may require the submission of an implementation plan as appropriate. If the total consolidated assets of the top-tier U.S. subsidiaries of the FBO fall below $50 billion for each of four consecutive quarters, the FBO will

no longer be subject to the IHC requirement and may dissolve the IHC. An FBO that plans to reduce its U.S. non-branch assets below the $50 billion level prior to July 1, 2016 to avoid the IHC requirement may submit a plan to the Federal Reserve that describes how the FBO intends to accomplish this reduction in U.S. non-branch assets.

4. Regulation of the IHC

The IHC is intended to be the "platform" for the Federal Reserve to supervise and regulate the U.S. operations of FBOs consistently. Accordingly, each IHC will be subject to the panoply of enhanced prudential standards, including risk management, capital, leverage, liquidity, capital planning and stress testing requirements, set forth in the final rules. Under the risk management requirements, IHCs must have a board of directors (or an equivalent body) to ensure strong, centralized corporate governance. Additionally, as discussed in Section D below, IHCs must have a risk committee of the board of directors to oversee the risk management framework of the IHC's operations (which can also oversee the FBO's combined U.S. operations).

D. RISK MANAGEMENT REQUIREMENTS

The final rules also implement risk management provisions of Dodd-Frank applicable to U.S. operations of FBOs. Section 165(b) of Dodd-Frank requires the Federal Reserve to establish overall risk management requirements, while Section 165(h) requires the Federal Reserve to issue regulations requiring certain publicly traded companies (whether foreign or domestic) to establish risk committees.

1. U.S. Risk Committee

An FBO with $10 billion or more in total consolidated assets that has publicly traded stock and an FBO with total consolidated assets of $50 billion or more (regardless of whether its stock is publicly traded) is required to establish and maintain a U.S. risk committee at the board level, that (i) oversees the risk management policies of the company's combined U.S. operations and (ii) has at least one member having experience in identifying, assessing and managing risk exposures of large, complex firms. An FBO meeting these thresholds but with less than $50 billion in combined U.S. assets must certify to the Federal Reserve annually that its risk committee fulfills these requirements. An FBO with more than $50 billion in combined U.S. assets must maintain a U.S. risk committee that satisfies additional requirements. The final rules separately require an FBO with an IHC to establish a risk committee at the IHC level. An IHC-level risk committee may serve as the risk committee for the FBO's combined U.S. operations.

The degree of expertise required of the committee and the risk management framework required to be implemented by the committee depends upon the capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors of the FBO's combined U.S. operations. Generally, the risk committee may be (i) a standalone committee of the FBO's global board of directors; (ii) a part of the FBO's enterprise-wide risk committee (in the case of public FBOs with more than $10 billion of consolidated assets or FBOs with $50 billion or more

in consolidated assets but less than $50 billion in combined U.S. assets); or (iii) as a joint committee with the enterprise-wide risk committee or a committee of the board of directors of the IHC (in the case of FBOs with $50 billion or more in combined U.S. assets).[3]

The risk committee of any FBO with $50 billion or more in combined U.S. assets (including the risk committee of any IHC) must meet at least quarterly and must include at least one independent member who is not an officer or employee of the FBO or its affiliates, has not served in such capacity in the previous three years and is not an immediate family member of a person who has been an executive officer of the FBO or its affiliates in the previous three years.

2. *U.S. Chief Risk Officer*

An FBO with $50 billion or more in combined U.S. assets is also required to employ a U.S. chief risk officer with appropriate expertise to oversee the risk management framework of the U.S. operations. The U.S. chief risk officer must report directly to the U.S. risk committee and the company's global chief risk officer and must be employed by a U.S. subsidiary or U.S. office of the FBO. In the preamble to the final rules, the Federal Reserve made clear that the U.S. chief risk officer's primary responsibility should be for U.S. risk management, and he or she should not also serve as the FBO's global chief risk officer.

E. RISK-BASED CAPITAL REQUIREMENTS AND LEVERAGE LIMITS

When an FBO has sought to establish a branch, agency, or bank in the United States, the Federal Reserve has traditionally relied on an FBO's satisfaction—on a consolidated basis—of capital requirements imposed by its home country banking supervisor, provided that such requirements are equivalent to those required of a U.S. banking organization. In addition, since 2001, the Federal Reserve has permitted the top-tier U.S. bank holding company subsidiaries of FBOs that qualify as financial holding companies to have little or even negative capital in reliance on Supervision and Regulation Letter 01-01. Under the final rules, and consistent with other provisions of Dodd-Frank, including the Collins Amendment (which requires the U.S. bank holding company of an FBO that relied on SR Letter 01-01 to meet the minimum capital requirements established for other U.S. bank holding companies by July 21, 2015), risk-based capital and leverage requirements applicable to U.S. bank holding companies will now apply to the top-tier U.S. holding company of an FBO with consolidated assets of $50 billion or more.

1. *Capital and Leverage Requirements for FBOs*

Under the final rules, an FBO with total global consolidated assets of $50 billion or more must certify to the Federal Reserve that it meets capital adequacy standards at the consolidated level that are consistent with the regulatory capital framework established by the Basel Committee, as amended from time to time. An FBO will generally be permitted to rely on the capital adequacy standards established by its home country banking supervisor for purposes of this

---

[3] The final rules and preamble do not make clear whether there is any difference between the U.S. risk committee being "a part of" or in "a joint committee with" the FBO's enterprise-wide risk committee.

certification to the Federal Reserve. However, if an FBO's home country capital adequacy standards are not consistent with the Basel capital framework, the FBO must demonstrate to the Federal Reserve that it would nevertheless satisfy standards consistent with the Basel capital framework. The preamble to the final rules noted that the Federal Reserve will consider materiality when assessing the consistency of an FBO's home country capital standards with those of the Basel capital framework, and will take into account the timeliness with which the FBO's home country regulator implements any Basel capital framework standards and analyses regarding the comparability of capital standards, including the Basel Committee's own peer review process.

The capital adequacy certification required under the final rules would be made concurrently with the organization's FR Y-7Q filing (which is made on a quarterly basis for an FBO that has elected to become a financial holding company and on an annual basis for all other FBOs), and the Federal Reserve may impose conditions or restrictions (including risk-based capital or leverage requirements) on the U.S. activities or business operations of an FBO that fails to comply.

2. *Capital and Leverage Standards for IHCs*

Every IHC established by an FBO pursuant to the final rules, regardless of whether it controls a bank, will generally need to satisfy all capital adequacy standards applicable under the standardized approach of Regulation Q, including minimum risk-based capital and leverage standards,[4] and comply with all restrictions associated with applicable capital buffers, in the same manner and to the same extent as those applicable to U.S. bank holding companies. As noted above, however, the final rules have delayed applicability of the leverage ratio requirements until January 1, 2018. By contrast, the U.S. branch and agency networks of an FBO would continue to be evaluated based on the FBO's satisfaction of its home country's capital requirements on a consolidated basis (as described in item 1 above).

Notably, however, the final rules exempt IHCs from complying with the advanced approaches risk-based capital rules under Subpart E of Regulation Q, regardless of whether the IHC would otherwise meet the thresholds for application of those rules.[5] Furthermore, the final rules allow a U.S. bank holding company subsidiary of an FBO that had previously been subject to the advanced approaches rules to opt out of compliance with those rules with prior approval by the Federal Reserve.

---

[4] The capital adequacy standards applicable under the standardized approach of Regulation Q include (i) a minimum common equity tier 1 risk-based capital ratio of 4.5%, (ii) a tier 1 risk-based capital ratio of 6%, (iii) a total risk-based capital ratio of 8%, and (iv) a leverage ratio of tier 1 capital to average total consolidated assets of 4%.

[5] The advanced approaches risk-based capital rules, which impose specific risk measurement and management criteria that must be met when calculating risk-based capital requirements, generally apply to U.S. bank holding companies with total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposures of at least $10 billion.

Despite being exempt from the advanced approaches rules, an IHC with total consolidated assets of at least $250 billion or total consolidated on-balance sheet foreign exposures of at least $10 billion will nevertheless be subject to other requirements of Regulation Q that apply only to bank holding companies that meet the advanced approaches rules thresholds, but that are not part of the advanced approaches rules themselves. For example, IHCs meeting the advanced approaches rules thresholds will be subject to Regulation Q's restrictions on distributions and discretionary bonus payments associated with the countercyclical buffer, the supplementary leverage ratio of 3% and the requirement to include accumulated other comprehensive income (AOCI) in regulatory capital.

F. CAPITAL STRESS TESTING AND CAPITAL PLANNING REQUIREMENTS

1. *Capital Stress Testing Requirements*

Section 165(i)(1) of Dodd-Frank directs the Federal Reserve to conduct annual supervisory capital stress tests of certain supervised organizations with total consolidated assets of $50 billion or more, including FBOs, and to make publicly available a summary of the results of those tests. In addition, Section 165(i)(2) of Dodd-Frank requires certain supervised organizations with total consolidated assets of more than $10 billion, including FBOs, to conduct company-run capital stress tests and publish a summary of the results of the company-run stress tests. The final rules implement these DFAST requirements based on the size of the FBO and its U.S. operations.

a. *FBOs with Total Consolidated Assets of More Than $10 Billion and FBOs with Total Consolidated Assets of $50 Billion or More but Combined U.S. Assets Below $50 Billion*

The final rules apply capital stress testing to (i) FBOs with total consolidated assets of more than $10 billion but less than $50 billion, (ii) foreign savings and loan holding companies with total consolidated assets of more than $10 billion and (iii) FBOs with total consolidated assets of more than $50 billion but combined U.S. assets below $50 billion. These companies must satisfy these requirements through capital stress tests conducted or overseen by their home country supervisor on a consolidated basis. They are not subject to separate information requirements of the Federal Reserve related to the results of their home country stress tests. However, if the home country stress testing regimes do not qualify or if these companies failed to satisfy the minimum standards of their home country stress tests, they would be subject to a requirement to maintain a level of U.S. eligible assets of 105% of U.S. liabilities,[6] annual stress tests of their U.S. subsidiaries and an obligation to report the results and methodologies of their stress tests to the Federal Reserve.

---

[6] This requires the FBO to maintain eligible assets in its U.S. branches and agencies that, on a daily basis, are not less than 105% of the average value over each day of the previous calendar quarter of the total liabilities of all of the FBO's U.S. branches and agencies. Notably, eligible assets exclude (i) equity securities, (ii) assets classified as loss, (iii) accrued income on assets classified loss, substandard or value impaired, and (iv) amounts due from the home office or other affiliates.

b. FBOs with Combined U.S. Assets of $50 Billion or More

An FBO with total consolidated assets of $50 billion or more and combined U.S. assets of $50 billion and that maintains a U.S. branch or agency must satisfy stress testing requirements through stress tests overseen by its home country supervisor.

Such an FBO is also required to submit by January 5 of each year to the Federal Reserve detailed information regarding these stress testing activities, including the methodologies, scenarios and results of its home country stress tests. In addition, when a U.S. branch and agency network is in a "net due from" position to its foreign bank parent or affiliates, the FBO also would be required to report additional information to the Federal Reserve, including any information that the Federal Reserve deems necessary to evaluate the ability of the FBO to absorb losses under stressed conditions.

If the FBO does not meet the capital stress test requirements of its home country, fails to comply with the reporting requirements above or the FBO's home country stress tests do not qualify, then:

- the FBO would be subject to a U.S. eligible asset maintenance requirement of 108% of U.S. liabilities;
- if the FBO has not established an IHC (because its non-branch and agency assets are less than $50 billion), the FBO would be required to conduct an annual stress test of its U.S. subsidiaries to determine whether they have the capital necessary to absorb losses; and
- the Federal Reserve may impose intragroup funding restrictions on the FBO's U.S. operations.

c. IHCs

In October 2012, the Federal Reserve issued a final rule implementing the supervisory and company-run stress testing requirements for U.S. bank holding companies. The final rules implement domestic stress test requirements for an IHC consistent with those required of U.S. bank holding companies.[7] An IHC must conduct two company-run stress tests each year, one using scenarios provided by the Federal Reserve (the "annual test") and one using scenarios developed by the company (the "mid-year test"). The annual test would occur in the fall and would be reported to the Federal Reserve by January 5, with results made public in March, each year. Results of the mid-year test would be provided to the Federal Reserve by July 5, with results made public in September. Additionally, the Federal Reserve will conduct an annual supervisory stress test of the IHC using scenarios identical to those provided for the company-run annual test. The IHC must file regulatory reports that contain information to support the

[7] The DFAST rule from October 2012 has not been changed by the final rules. The final rules have only re-categorized the supervisory and company-run related components to Subparts E and F of Regulation YY, respectively.

Federal Reserve's supervisory stress tests. The Federal Reserve will disclose a summary of the results of its supervisory stress test no later than March 31 of each calendar year.

An IHC that meets the $50 billion U.S. non-branch asset threshold as of June 30, 2015 would be required to comply beginning with the DFAST cycle that commences on October 1, 2017, meaning that the deadline for the IHC to submit its company-run annual stress test results is January 5, 2018.

2. *Capital Planning for IHCs*

The final rules require all IHCs to comply with the capital plan rule under Section 225.8 of Regulation Y. This rule, which currently applies to large U.S. bank holding companies (except those relying on SR 01-01, which are exempt until July 21, 2015), requires the submission of annual capital plans to the Federal Reserve detailing how minimum risk-based capital ratios are satisfied—under both baseline and stressed scenarios—over a minimum nine-quarter, forward-looking planning horizon. Dividends and share repurchases are permitted only to the extent reflected in an approved capital plan. Failure to submit a satisfactory capital plan would result in restrictions on the IHC's ability to make capital distributions (including redemptions or repurchases of any debt or equity capital instrument and payment of dividends on common or preferred stock). IHCs that are formed by the July 1, 2016 implementation deadline will be required to submit their first capital plan to the Federal Reserve by January 5, 2017.

G. LIQUIDITY REQUIREMENTS

As part of the Federal Reserve's continuing effort to address the risks to financial stability posed by FBOs' increased use of short-term funding and exposure to maturity mismatches, the final rules seek to improve the overall liquidity resiliency of the U.S. operations of FBOs and to reduce the need for parent and government support during periods of stress. In general, the liquidity requirements largely track those set forth in the final rules applicable to domestic banking organizations, and would apply only to those FBOs with total consolidated assets of $50 billion or more (with more stringent requirements applicable to those FBOs with combined U.S. assets of $50 billion or more).

The liquidity requirements are divided into three broad categories: (i) requirements related to the management of liquidity risk, (ii) liquidity stress testing requirements, and (iii) a requirement that an FBO establish a buffer of highly liquid assets that could be sold or pledged to withstand liquidity stress for a specified time horizon under adverse conditions.

1. *Enhanced Liquidity Risk Management Standards*

The final rules require an FBO with combined U.S. assets of $50 billion or more to take a number of prudential steps to manage liquidity risk, including the following:

- Liquidity Risk Tolerance Review—The FBO's U.S. risk committee (described above) must:
  - review and approve, at least annually, the acceptable level of liquidity risk that the FBO may assume in connection with its combined U.S. operations,

with concurrence of the FBO's board of directors or its enterprise-wide risk committee;

- o determine, at least semi-annually, whether the FBO's U.S. operations are operating in accordance with the established liquidity risk tolerance; and
- o approve a contingency funding plan for the FBO's combined U.S. operations at least annually.

The FBO's U.S. chief risk officer must review the FBO's liquidity risk management policies and procedures established by senior management, and must approve the liquidity costs, benefits, and risks of each new product and business line offered, managed, or sold through the FBO's U.S. operations. For existing significant business lines and products, the U.S. chief risk officer must determine, at least annually, whether the business line or product creates any unanticipated liquidity risk and whether the liquidity risk associated with each business line or product continues to be within the FBO's liquidity risk tolerance.

- *Independent Review of Liquidity Risk Management Practices*—The FBO must establish and maintain a liquidity risk management review function that is independent of management functions responsible for executing the FBO's funding strategy for its U.S. operations. This independent review function must evaluate, at least annually, the effectiveness of the FBO's liquidity risk management processes within its U.S. operations.
- *Cash-Flow Projections*—The FBO must produce comprehensive cash-flow projections for its combined U.S. operations, with short-term cash-flow projections being updated daily, and at least monthly for longer-term cash-flow projections. The FBO's U.S. chief risk officer must review the cash-flow projections at least quarterly to ensure that the liquidity risk of the FBO's U.S. operations is within the FBO's established liquidity risk tolerance. Although the final rules do not require global cash-flow statements for all activities conducted in U.S. dollars without reference to whether those activities were conducted through the FBO's U.S. operations, the Federal Reserve noted that it will continue to consider the issue and may separately seek comment in the future on regulatory reporting requirements or information collection procedures pertaining to a firm's global U.S. dollar flow activities.
- *Contingency Funding Plan*—The FBO must establish and maintain a contingency funding plan that outlines the firm's strategies for addressing liquidity needs in circumstances where normal sources of funding may not be available. In particular, each contingency funding plan must include (i) a quantitative assessment of future liquidity needs and funding sources, (ii) an event management process that sets out the procedures for managing liquidity during identified liquidity stress events, (iii) procedures for monitoring emerging liquidity stress events, and (iv) periodic testing of the components of the contingency funding plan to assess its reliability during liquidity stress events. The Federal Reserve clarified in the preamble to the final rules that the implementation of an FBO's contingency funding plan should include a periodic liquidation of assets, including portions of the FBO's liquidity buffer in certain instances.

- *Liquidity Risk Limits*—The FBO, through its U.S. chief risk officer, must establish and maintain specific limits on potential sources of liquidity risk, including (i) concentrations of funding by instrument type, single-counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers; (ii) the amount of specified liabilities that mature within various time horizons; and (iii) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events. The FBO's U.S. chief risk officer must review compliance with such limits at least quarterly (or more often if warranted by changes in market conditions or the liquidity risk profile of the U.S. operations of the FBO).
- *Monitoring of Liquidity Risk and Collateral Positions*—The FBO must monitor its liquidity risk and collateral positions, as well as its intraday liquidity positions, for its U.S. operations, including across significant legal entities, currencies, and business lines.

2. *Liquidity Stress Testing Requirements*

In an effort to help FBOs identify financial vulnerabilities and quantify the depth, source and degree of potential liquidity strain in their U.S. operations, the final rules require FBOs with at least $50 billion in total consolidated assets to conduct periodic internal liquidity stress tests.

For an FBO with at least $50 billion in total consolidated assets but combined U.S. assets of less than $50 billion, the final rules require annual liquidity stress tests for either the FBO's consolidated global operations or its combined U.S. operations. The liquidity stress tests for such an FBO must be consistent with the Basel Committee's principles for liquidity risk management and must, at a minimum, include stress tests with 30-day, 90-day, and one-year time horizons. If an FBO fails to comply with the annual liquidity stress test requirement, the net aggregate amount owed by the FBO's non-U.S. affiliates to the FBO's combined U.S. operations must not exceed 25% of the third-party liabilities of the FBO's combined U.S. operations.

For an FBO with consolidated assets of $50 billion or more and combined U.S. assets of $50 billion or more, the final rules require separate monthly liquidity stress tests for the FBO's combined U.S. operations, and for the FBO's IHC (if any) and for the FBO's U.S. branches and agencies. In addition to the monthly stress testing requirement, the U.S. operations of such FBOs may be required to conduct more frequent stress tests at the request of the Federal Reserve. In designing the required liquidity stress tests, the FBO must incorporate a range of forward-looking adverse liquidity scenarios required in the final rule and must include an overnight time horizon, in addition to the 30-day, 90-day, and one-year stress tests required as referenced above. The required liquidity stress tests for the FBO would be based on the FBO's own models and assumptions for run-off rates and haircuts that are appropriate for the liquidity risks and business models of the FBO's U.S. operations. This internal-models-based approach to stress testing under the final rules is intended to complement the standardized quantitative liquidity coverage ratio rules published by the Basel Committee (the "Basel III LCR") and those that were proposed by the Federal Reserve in October 2013 (the "Proposed

U.S. LCR"),[8] both of which are intended to facilitate an assessment of liquidity positions across firms under a standardized stress scenario. In the preamble to the final rules, the Federal Reserve signaled that it intends to implement the quantitative liquidity standards included in Basel III for the U.S. operations of some or all FBOs with $50 billion or more in combined U.S. assets through future separate rulemakings.

The final rules require the U.S. chief risk officer of an FBO with $50 billion or more and combined U.S. assets of $50 billion or more to approve the liquidity stress testing practices, methodologies and assumptions at least quarterly, as well as whenever the FBO materially revises its liquidity stress testing policies or assumptions. At a minimum, the FBO's stress test must incorporate the following assumptions:

- For the first 30 days of a liquidity stress scenario, only highly liquid assets that are unencumbered may be used as cash flow sources; after such the first 30 days other appropriate funding sources also may be used as cash flow sources;
- For stress tests with a planning horizon of 30 days or less, a line of credit does not qualify as a cash flow source, and internal cash inflows may be used only to offset internal cash outflows. For stress tests with a planning horizon of more than 30 days, a line of credit may qualify as a cash flow source, and internal cash inflows may be used to offset both internal and external cash outflows;
- If an asset is used as a cash flow source, the fair market value of the asset must be discounted to reflect any credit risk and market price volatility of the asset; and
- Throughout each stress test time horizon, assets used as funding sources must be diversified by collateral, counterparty, or borrowing capacity, or other factors associated with the liquidity risk of the assets.

The final rules also require that an FBO with $50 billion or more of consolidated assets and combined U.S. assets of $50 billion or more provide to the Federal Reserve the results of any liquidity stress testing in a timely manner.

3. *Liquidity Buffers*

To further bolster an FBO's ability to withstand an acute liquidity stress scenario, the final rules require any FBO with combined U.S. assets of $50 billion or more to maintain separate liquidity

---

[8] The Proposed U.S. LCR would require internationally active banking organizations and nonbank financial companies supervised by the Federal Reserve to hold an amount of high-quality liquid assets sufficient to meet expected net cash outflows under a supervisory stress scenario over a 30-day time horizon. It would also apply a less stringent, modified liquidity coverage ratio to bank holding companies with total consolidated assets between $50 billion and $250 billion that do not meet the thresholds for an internationally active banking organization. For a more detailed summary of the Proposed U.S. LCR, please see our memorandum titled, "New Quantitative Liquidity Requirements Proposed," dated October 29, 2013, *available at* http://www.stblaw.com/about-us/news/details?id=29a6930b-78f4-47cf-98ba-72929fc12035.

buffers for its IHC and for its U.S. branch and agency network that are sufficient to meet projected net stressed cash flow needs over specified stress test time horizons.

Each liquidity buffer must consist of unencumbered, highly liquid assets. An asset may be regarded as "unencumbered" if it is free of legal, regulatory, contractual or other restrictions on the ability of the firm to monetize the asset, and not subject to any pledge or lien (except to the extent pledged to a central bank or U.S. GSE other than to secure credit extended by such central bank or U.S. GSE). Highly liquid assets include (i) cash, (ii) securities issued or guaranteed by the U.S. government, a U.S. government agency, or a U.S. GSE, and (iii) any other asset that the FBO demonstrates, to the satisfaction of the Federal Reserve, has low credit and market risk, an active two-way market, and is a type of asset that investors historically have purchased in periods of financial market distress during which market liquidity is impaired.

In the case of an FBO's IHC, the liquidity buffer must be sufficient to meet the IHC's projected net stressed cash flow need over a 30-day liquidity stress scenario. In the case of an FBO's U.S. branches and agencies, the liquidity buffer must be sufficient to meet the U.S. branches' and agencies' projected net stressed cash flow need over the first 14 days of a 30-day liquidity stress scenario. To calculate the size of its required liquidity buffer in each case, an FBO may use the results of its 30-day liquidity stress test required under the final rules (as described above), and the FBO's U.S. chief risk officer must approve the size and composition of the liquidity buffer at least quarterly.

Under the final rules, an FBO must maintain the assets comprising the liquidity buffers for both its IHC and its U.S. branches and agencies in accounts in the United States. To the extent that its liquidity buffer's assets consist of cash, an IHC may not hold the cash in an account located at a U.S. branch or agency of the FBO, or at any other affiliate that is not controlled by the IHC. Likewise, an FBO's U.S. branch or agency may not hold the cash portion of its liquidity buffer in an account located at the FBO's IHC or other affiliate.

H. DEBT-TO-EQUITY LIMITS

Under Section 165(j) of Dodd-Frank, if the FSOC determines that an FBO with total consolidated assets of $50 billion or more (i) poses a "grave threat" to U.S. financial stability and (ii) the imposition of a debt-to-equity 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. The final rules implement this limitation at the IHC level and for any subsidiary not organized under such structure. The final rules define "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. The 15-to-1 debt-to-equity ratio is calculated as the ratio of total liabilities to total equity capital minus goodwill. Additionally, the final rules impose an asset maintenance requirement of 108% on such FBOs.

The debt-to-equity limit and asset maintenance requirement are effective on June 1, 2014. An FBO that is subject to a "grave threat" determination by the FSOC will receive written notice from the FSOC. After receiving such notice, the FBO 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 will remain in effect until the FSOC determines that a particular FBO no longer poses a grave threat to U.S. financial stability and that the imposition of the leverage limitation is no longer necessary.

* * *

For more information about the final rules and how they may impact your organization, please contact any of the members of our Financial Institutions group, as listed below.

Financial Institutions

Lee Meyerson
(212) 455-3675
lmeyerson@stblaw.com

Maripat Alpuche
(212) 455-3971
malpuche@stblaw.com

Mark Chorazak
(212) 455-7613
mchorazak@stblaw.com

Elizabeth Cooper
(212) 455-3407
ecooper@stblaw.com

Randy Benjenk
(212) 455-2307
randy.benjenk@stblaw.com

Spencer Sloan
(212) 455-7821
spencer.sloan@stblaw.com

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

The contents of this publication are for informational purposes only. Neither this publication nor the lawyers who authored it are rendering legal or other professional advice or opinions on specific facts or matters, nor does the distribution of this publication to any person constitute the establishment of an attorney-client relationship. Simpson Thacher & Bartlett LLP assumes no liability in connection with the use of this publication.

UNITED STATES

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

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

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

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

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

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

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

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

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82-2-6030-3800

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

SOUTH AMERICA

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