Financial Services Management

Systemic Regulation

Corporate Planning	Risk Management Action Item

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Enhanced Prudential Standards
and Early Remediation Requirements for Covered Companies

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Overview

In this report, FedFin continues the in-depth analysis of the FRB's systemic regulations, building on a prior report that assessed the NPR's overall framework and analyzed its capital, liquidity and credit-exposure provisions.[1] Here, we turn to the risk-management, stress-test, debt-to-equity limit and early-remediation proposals; these also pose significant strategic and operational challenges for BHCs with assets over $50 billion and, when designated, systemic nonbank financial companies.[2] However, provisions in the NPR related to board risk committees and stress tests analyzed here also reach BHCs and banks with assets above $10 billion, expanding the scope of these rules to regional institutions otherwise outside the systemic safeguards.

[1] See SYSTEMIC54, *Financial Services Management*, January 3, 2012.

[2] See SYSTEMIC51, *Financial Services Management*, October 21, 2011.

Impact

As noted, a prior client report provides a detailed analysis of the Dodd-Frank requirements stipulating this NPR[3] and the overall framework proposed by the FRB in consequence. Key questions there and in the remaining sections of the NPR include the degree to which standards in this sweeping rule will vary by size of the affected BHC and/or by the nature of any systemic nonbanks. This issue is not clearly addressed in the capital standards (except with regard to G-SIBs)[4], or liquidity and credit-exposure provisions. As noted, several provisions analyzed here do vary by size of affected firm, but largely by bringing in banks and BHCs with assets below the $50 billion systemic threshold. As in the rest of the rule, little here graduates requirements based on the size or complexity of the affected firm, although the NPR does state that the FRB will take this into account. And, as with the rest of the NPR, the provisions analyzed here do not clearly specify how non-bank systemically-important financial institutions (SIFIs) will be covered when the BHC-focused criteria expressly mandated are at odds with their business and/or regulatory structure. The FRB has indicated that it will address this in future rulemakings and on a case-by-case basis; how it does so will have far-reaching strategic impact on affected SIFIs, possibly leading them either to adopt the BHC model or reduce operations to a scale no longer deemed systemic.

The implications of the sections of the NPR analyzed here include:

Risk Management

To date, the FRB has not applied formal regulations that mandate enterprise-wide risk management at larger BHCs, although it has frequently spoken of the need to ensure an appropriate corporate “culture” and requisite controls.[5] The NPR argues that the Board here is principally formalizing prior supervisory guidance and extending it (in principle) to nonbank SIFIs. While some BHCs will not find the broad framework for risk management different than that implemented under prior Board guidance, most will need to make structural and operational risk-management changes (especially to the board of director’s work here). For example, the express duties of risk committees are very extensive and proposed independence requirements could force BHCs to change membership of current committees, perhaps making it difficult to attract eligible directors and/or forcing overall board restructuring to meet both eligibility requirements and desired total board-composition standards. Nonbanks often lack any comparable risk committees or the now-required chief risk officers (CROs), thus forcing still more significant change for SIFIs.

[3] See SYSTEMIC29, *Financial Services Management*, July 13, 2010.

[4] See CAPITAL180, *Financial Services Management*, November 16, 2011.

[5] See Client Reports in the CORPGOV and RISKMANAGEMENT series.

Stress Tests

The NPR builds on stress-test exercises mandated by the FRB since 2009[6] including the most recent, stringent tests now under way to determine the degree to which BHCs with assets over $50 billion may make capital distributions.[7] However, again as required by the law, the FRB now also proposes three stress-test standards, reaching below the $50 billion threshold also to cover BHCs, S&L holding companies and state member banks with over $10 billion in assets and expanding the stress-test construct to systemic nonbanks. This is required by the Dodd-Frank Act, but much in the proposed stress-test framework is so based on current BHC requirements that the text in fact only references BHCs in several respects. The Board does not propose to withdraw the ongoing stress tests, meaning that BHCs with assets over $50 billion would apparently be subject to at least four stress tests (with the complexity of the testing regime complicated by the fact that the primary regulator of subsidiary banks within a BHC may require different stress-testing protocols even though the NPR notes efforts at coordination). Comment is solicited on the burden of the proposed stress tests, likely eliciting protests on this front from affected institutions.

Importantly, the Board would premise regulatory action on stress-test results. This would go beyond the direct restrictions on capital distributions (e.g., dividends) included in the current large-BHC stress tests also to require changes such as reduced credit exposures and rewrites to a firm's living will.[8] Early remediation (see below) could also be initiated based on supervisory stress-test results, with the combination of these factors making clear that, regardless of burden, the tests will be vital strategic factors for covered firms.

As dictated by Dodd-Frank, covered companies will also be required to disclose test results. The NPR details key factors for these releases, which would need to include forward-looking income and loss projections now often not provided by firms. Assessing the strategic impact of these disclosures and their relationship to the requirements applicable to publicly-traded firms in the U.S. under the securities laws will be another major consideration and focus of comment.

Debt-to-Equity Limits

The Dodd-Frank Act also requires that any company found by the FSOC to pose a "grave threat" is subject to a 15:1 debt-to-equity ratio. The NPR

[6] See Client Reports in the STRESS series.

[7] See STRESS10, *Financial Services Management*, December 1, 2011.

[8] See LIVINGWILL7, *Financial Services Management*, October 12, 2011.

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addresses what would happen upon any such designation, giving affected firms at least 180 days to meet the new requirement. For many firms, especially those in difficulty, a 15:1 debt-to-equity ratio would pose a serious challenge, with the provision thus likely to be used principally as a premise for emergency FSOC and FRB action. However, it could also short-circuit the process for designating nonbank financial companies as systemic institutions, since the FSOC statement triggering this limit is not subject to the appeal process and other constraints applicable under the systemic-designation process once finalized.

Early Remediation

The NPR not only stipulates an array of standards covered firms must meet, but also outlines a series of increasingly stringent sanctions the FRB would impose on troubled entities. As in the Dodd-Frank Act, the NPR called this early remediation, building on the "prompt corrective action" (PCA) framework already in place for insured depositories. However, the early-remediation standards are considerably more stringent than PCA, most importantly by virtue of the fact that non-discretionary, tough restrictions on capital distributions and growth are imposed when a firm falls below the "well-capitalized" threshold. This is set to rise significantly for BHCs under the Basel III rules[9] once these are implemented in the U.S.; the FRB thus notes that it may revise this aspect of the early-remediation standards once the Basel rules are in place (presumably to ensure that sanctions are not so frequently imposed that the U.S. capital ratio is effectively well above the Basel thresholds).

In addition to capital, early remediation would be triggered by other factors: the results of the supervisory stress test (reinforcing the strategic impact noted above), failure to meet the risk-management and liquidity standards proposed in the NPR, and/or "market indicators (with the NPR posing questions about the value of pricing and similar factors as meaningful warnings of prudential risk). The NPR indicates that the FRB considered a quantitative threshold for liquidity that, like capital, would trigger sanctions; it decided against this on grounds that this could increase funding pressure on troubled firms, but seeks comment on whether to introduce a hard-wire standard. Certain balance-sheet triggers (e.g., non-performing loans, loan concentrations) were also considered, but not proposed because the FRB fears these are not useful for nonbanks. However, comment on these triggers is requested.

The early-remediation levels increase to the worst one, at which the NPR indicates the Board would recommend to Treasury and the FDIC that resolution be commenced under the orderly-liquidation authority (OLA) process also instituted in Dodd-Frank.[10] Interestingly, nothing in the NPR

[9] See CAPITAL173, *Financial Services Management*, January 7, 2011.

[10] See Client Reports in the RESOLVE series.

suggests that the FRB would indicate to the firm's board that, absent immediate corrective action, the FRB would recommend to primary regulators like the FDIC that resolution be commenced for an insured depository or broker-dealer and that the firm otherwise be ordered to commence resolution under the Bankruptcy Code or other applicable insolvency regime. It is, of course, unclear if any of these would suffice for a SIFI, but the suggestion in the NPR that only OLA would be utilized for a SIFI may reinforce expectations that, despite all the reforms in Dodd-Frank, these firms are still too big to fail.

What's Next

This NPR was published in the *Federal Register* on January 5; comments are due by March 31. Other regulators are now working on aspects of it, with the FDIC issuing its stress-test proposal on January 17.[11] BHCs and state member banks subject to the FRB's company-run stress test requirements would be governed on the final rule's effective date for purposes of the filing schedule detailed in the NPR; S&L holding companies would, however, not come under these standards until the broader FRB regulatory framework for them is finalized.

Analysis

I. Risk Management

A. Risk-Committee Requirements

Covered BHCs and nonbank SIFIs, along with publicly-traded BHCs with assets over $10 billion, would need to establish board-level risk committees to ensure enterprise-wide risk management on a worldwide basis.

1. Structure

Key requirements would include:

- that the committee at all applicable firms be chaired by an independent director. "Independence" would be defined as in applicable SEC regulations, with the FRB proposing also to make case-by-case independence determinations based on factors detailed in the NPR.

[11] See STRESS11, *Financial Services Management*, January 17, 2011.

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Comment is solicited on whether a different approach should be used to determine independence;

- that as many members of the risk committee as possible also be independent. The board seeks views on whether it should mandate more than one independent member;
- that at least one member of the committee have risk-management expertise (also defined in the NPR). However, all members of the committee would need to have risk-management expertise commensurate with the company's size and complexity. Comment is sought on whether expertise criteria should be stipulated by rule; and
- compliance with procedural requirements for the risk committee (e.g., use of a formal charter, regular meetings, documentation, etc.).

2. *Responsibilities*

The risk committee would need to:

- approve a risk-management framework appropriate for the firm. This would need to include limits and risk expectations for each "business line," along with governance and infrastructure requirements;
- ensure that risk-management systems track compliance;
- ensure effective and timely correction; and
- specify required duties related to risk management, including links between risk-management goals and compensation.

Questions are posed as to the degree to which these duties are appropriate for the board.

B. Additional Risk-Management Standards

These standards would apply to BHCs with over $50 billion and any systemic nonbanks.

1. *CROs*

All covered companies would need to have a chief risk officer with duties and authority detailed in the NPR. The CRO is responsible for worldwide, enterprise-wide risk management and thus would need expertise commensurate with a firm's full operations. CROs are to report directly to the board risk committee and CEO and to be compensated so that objective risk judgment is provided. Comment is solicited on whether CRO minimum criteria should be stipulated by rule.

2. *Risk Committee*

Building on the requirements above, covered companies would also need to separate the risk committee from other board committee functions. Thus, risk-management responsibilities could not be subsumed in other bodies (e.g., the audit committee) or conducted jointly with them.

II. Stress Tests

The NPR includes a table detailing when each of the filings and disclosures outlined below would be required in the course of a calendar year. Comment on its feasibility is requested.

A. Annual FRB Supervisory Stress Tests

These would be conducted by the FRB based in part on information provided in regular filings, not special exercises or examinations similar to the recent stress tests noted above; however, additional information could be demanded if needed. The tests will be, like prior ones, forward-looking exercises designed to ensure capital adequacy over the next nine quarters under three different economic scenarios to be published by the FRB. The overall data framework for these tests will be proposed in a separate request for comment. The scenarios for stress tests will also be published each year in advance, along with an overview of their methodology (which is also summarized in the NPR).

As required, summary "high-level" disclosures will be made by the FRB of its conclusions after these are first released to the company for possible rebuttal, with comment solicited on the specifics of the proposed company-specific releases. Firms would need to make changes to their operations based on stress-test results (e.g., addition of capital, restructuring of capital components, reduction to credit exposures, improved risk management and updates of resolution plans). These internal actions would need to be within ninety days of receiving the Board's conclusions. The results could also trigger early remediation (see below).

B. Company Stress Tests

1. Framework

These tests would be required semi-annually from BHCs with over $50 billion in assets and systemic nonbanks; BHCs, S&L holding companies and state member banks with assets over $10 billion would conduct the test on an annual basis. Banks with assets over $10 billion are also to be subject to stress tests under rules to come from the OCC and FDIC; the FRB notes its intention to coordinate with these regulators to limit the burden associated with varying tests under potentially different scenarios for banks within the same holding company. The tests focus largely on company-specific capital issues, with the FRB noting that they will form only part of the broader stress tests required to assess the full array of likely risks (e.g., liquidity risk). Capital adequacy is to be judged on general criteria, as well as on the degree

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to which regulatory standards are met (with the NPR not specifying which regulations – e.g., Basel II or III) are to be anticipated.

The company-run stress-test data would be kept confidential by the FRB.

2. Disclosure

Companies would need to disclose summaries of their results ninety days after submitting them to the FRB. Disclosure at a minimum would need to include:

- a description of risks taken into account;
- a high-level scenario description of the company's own test;
- a general description of the methodology; and
- aggregate losses, provisions, projected income and pro forma capital for each quarter in the test horizon.

3. Tests

A separate proposal will be issued by the FRB on the specifics of the company-run test and the data required for it. In general, firms would need to conduct these tests on the same three scenarios provided each year by the FRB for the supervisory stress tests outlined above, although the semi-annual test for covered companies would be conducted under company-derived scenarios and any other FRB-dictated factors. A set of governance, validation and control requirements is proposed to ensure the tests are rigorous, forward-looking and in compliance with applicable rules. The board and senior management need annually to approve both the test results and sufficiency of relevant controls. An annual report to the board will be required under procedures to be separately proposed by the FRB (although the NPR includes an array of factors in this area).

4. FRB Review

The Board will review these company-run tests in conjunction with its regular supervisory operations, also looking at the degree to which the firm modified its capital structure or planned distributions based on test results.

III. Debt-to-Equity Limits

As noted, the Act requires a 15:1 debt-to-equity ratio for any company found by the FSOC to pose a grave threat to U.S. financial stability, where this threat is reduced by the limit. The NPR defines debt and equity largely in accord with applicable BHC filings, making it unclear how this would apply to nonbanks, with equity defined as total equity capital less goodwill. Federal Home Loan Banks are excluded from this framework, as stipulated in the Act.

As noted, compliance is largely required 180 days after notice, but the law and NPR allow for two ninety-day extensions of this deadline. The NPR does not detail how firms are to come into compliance with this limit if notified that they have been targeted under it. The NPR does, however, indicate that firms should do so in a prudent fashion (e.g., through a good-faith effort to limit capital distributions and/or raise capital before any asset disposition). The limits no longer apply if the FSOC determines the firm no longer poses a grave threat or, presumably, if this ratio has no risk-reduction benefit.

IV. Early Remediation

A. Levels

The NPR stipulates four levels for intervention:

- heightened supervisory review through a targeted FRB examination. This would be done in thirty days to determine if the following levels should be invoked. There is no minimum capital threshold triggering this review;
- initial remediation, including possible restrictions on growth, capital distribution, acquisitions/branch expansion and restrictions on business activities. These would be imposed once a firm slips below the well-capitalized level generally through a non-public action;
- recovery, when prohibitions on growth and capital distribution, limits on executive compensation, requirements for more capital and any other sanctions stipulated by the FRB would apply under a formal (public) enforcement action. If dissatisfied with the firm's responses, divestitures could also be required. Removal of "culpable" management and/or restrictions on inter-affiliate transactions could also be imposed; and
- recommended resolution, when the Board would recommend to Treasury and the FDIC that the firm be handled through the orderly-liquidation authority of Dodd-Frank because risk-based or leverage capital standards are not met and, thus, the criteria in Dodd-Frank for OLA apply.

The FRB would notify the primary regulator of a covered firm as early remediation is triggered. Notification would not apparently extend to consultation, meaning that primary regulators that dissent with the Board's decision would have no clear opportunity to comment on it.

B. Triggers

Triggers for early remediation would include not only capital, but also:

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- supervisory stress-test results, with the Board seeking comment on whether triggers should also be based on failure to handle the severely-adverse scenario;
- identified weakness in the systemic risk-management and liquidity standards imposed elsewhere in the NPR; and
- "market indicators." Due to concerns about this factor, the FRB would use it only to trigger level-one early remediation (increased supervisory review), while continuing to study it. A future proposal would lay out these market indicators that would then be subjected to annual review. However, initially, the FRB plans to use equity-based indicators (e.g., default predictors, volatility indices) and debt-based indicators (e.g., CDS pricing, bond spreads).

The NPR includes a table that stipulates which level of early remediation would be triggered by lapses in each of these triggers. Despite the FRB's concern that these triggers be applicable across different types of SIFIs (not just BHCs), several of them (e.g., a five percent leverage requirement) are not widely applied to nonbanking organizations. Comment is solicited on these or other possible indicators, as well as on the indicator thresholds that would trigger early remediation.

C. Notice and Remedies

Early remediation and progress through its stages would begin only after notice from the FRB. Companies would have an affirmative duty to inform the FRB of triggering events and other changes.

D. Relation to Supervisory Powers

Early remediation supplements, but would not replace other FRB authority.