Financial Services Management

Large Holding-Company, Large-Bank Prudential Framework

Cite

FRB, Final Rule, Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations and FRB, OCC, and FRB, Final Rule, Changes to applicability thresholds for regulatory capital and liquidity requirements

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Websites:

https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a2.pdf

https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-fr-notice-20191010a1.pdf

Impact Assessment

- Although overall industry capital ratios will not drop significantly, U.S. regional banks gain significant capital relief. Super-regional BHCs gain less dollar relief, but their new framework is still less costly in terms of both required risk-based capital and the costs of compliance and capital governance.
- Regionals and certain super-regionals also win significant LCR relief that will translate into balance-sheet capacity which could be used for capital distributions, new lending, or other strategic purposes. Capital and liquidity relief will also permit overall strategic realignment into assets that may have been costly under the advanced approach that now come under the standardized rules or positions that created AOCI volatility. Higher ROA may result at affected companies along with the potential for additional risk.
- One SLHC will face significant new prudential standards as they enter new "categories."
- One small custody bank and any others with large cross-border operations to come will also face additional prudential requirements.
- Larger IHCs that come under Category III will also face additional U.S. prudential standards, although several are less onerous than initially feared.
- Foreign-bank branch-and-agency operations face no imminent danger of U.S. liquidity regulation.

- U.S. liquidity will now be judged at the IHC, not CUSO, level, further insulating the U.S. operation from implicit branch/agency liquidity requirements.

Overview

All of the U.S. banking agencies have adopted final versions of the "tailoring" standards proposed for domestic banking organizations with assets over $50 billion[1] and for foreign banking organizations (FBOs)[2] in 2018 without substantive change. The FRB has also adopted final standards mandated under the 2018 banking law[3] largely as initially proposed.[4] The FRB rules now also combine the tailoring standards the Board initially proposed on a stand-alone basis for FBOs.[5] As a result of all of these rules, the capital, liquidity, stress-testing, risk-management, and related prudential standards for domestic banking organizations not designated as GSIBs with assets over $100 billion would be less demanding. FBOs with combined U.S. operations (CUSO) above $100 billion will also see their rules tailored based on size and complexity along with standards for intermediate holding companies (IHCs) with assets over $100 billion. Prudential standards for smaller and non-complex companies will be particularly favorable, enhancing the potential for greater capital retention or distribution along with technological innovation, M&A, or other expansions. The proposal to advance liquidity standards for foreign branch-and-agency operations has been tabled pending possible agreement on global pre-positioning standards that would protect host countries.

Impact

Because the final rules largely track the proposal, they reject many of the alternatives that complicated analysis of implications for individual companies. For example, the NPR proposed not only the indicator-based approach in the final rules (see below), but also a model based on the GSIB-designation methodology.[6] The agencies decided against this because, as noted in FedFin's initial analysis, the GSIB approach was deemed less transparent, more complex, and less applicable to smaller companies. Even so, the new framework is complex, requiring companies on the brink of tougher rules (i.e., those with assets below $250 billion in the U.S. likely exceeding risk-indicator exposures) to calculate their own positions over the past year to determine into which category they fall and thus how significantly their prudential framework will change.

In general, the new framework redefines the U.S. regulatory-capital rules for all U.S. banking organizations with assets over $100 billion that are not GSIBs and for IHCs and, to a lesser extent, all large FBOs doing business in the U.S. This new framework essentially confines the application of the U.S. advanced approach to

1 See **SIFI30**, *Financial Services Management*, November 7, 2018.

2 See **FBO8**, *Financial Services Management*, April 18, 2019.

3 See **SIFI27**, *Financial Services Management*, June 4, 2018.

4 See **SIFI31**, *Financial Services Management*, November 18, 2018.

5 See **FBO9**, *Financial Services Management*, April 23, 2019.

6 See **GSIB7**, *Financial Services Management*, July 23, 2015.

risk-based capital[7] only to the U.S. GSIBs and one otherwise-undesignated U.S. custody bank. Reflecting this and as discussed below, the U.S. is now also considering simply eliminating the advanced approach altogether although this final rule does not make clear how this might be done or if the new framework would also apply to GSIBs. Ending the advanced approach and expanding the option not to recognize accumulated other comprehensive income (AOCI) will provide significant relief to BHCs with assets over $250 billion now under more costly and complex risk-based capital standards. Their relief is also greater than initially proposed because the banking agencies have decided to expand the capital relief granted earlier on mortgage servicing assets (MSAs) and other holdings now to all U.S. banking organizations that are not GSIBs or in Category II.[8]

The proposals for foreign banks included a suggestion that the Fed might proceed with a separate proposal for FBO branch/agency liquidity standards. Proponents have argued that these would protect the U.S. and particularly the Federal Reserve from risk if foreign banks under stress use their U.S. branches for large draws from the Fed or to take other U.S.-domiciled risk. Host countries of large foreign-banking operations share these concerns not only about liquidity risk, but also solvency risk in the event a foreign bank operating in their nation falters and is not supported by the parent bank in the home country due to its own distress or "ring-fencing" by the home-country regulator to safeguard the home country no matter the risk to host nations. Global negotiations about pre-positioning capital and liquidity to limit both home and host risks have dragged on for years, but the Fed's suggestion appears to have mobilized talks to more specific and possible action. Given this, the FRB decided to defer U.S.-only standards, thus also preserving U.S. banks from possible retaliation had the U.S. taken unilateral action.

As noted, this new framework applies to certain SLHCs – i.e., those that are not considered insurance-focused depository institution holding companies (DIHCs). Numerous SLHCs would come under the framework but for the fact that they are considered such DIHCs. The Fed has recently proposed a new, "building block approach" capital framework for these companies.[9] The final rule does not make it clearer than the NPR why the BBA framework could not apply to other SLHCs where functional regulators (e.g., the SEC) have subsidiary-level capital standards akin in concept to those for state-regulated insurance companies that the Fed plans to recognize in the building-block standards. Over time, these differences could make it easier for insurance-focused companies to acquire insured depositories while others fearful of BHC status and the new SLHC rules would not do so given the significant cost of the rules governing any large SLHC outside the insurance framework or commercial exemption.

However, for BHCs and FBOs under prior requirements, the new tailoring standards provide significant relief for all but designated U.S. GSIBs and the one smaller custody bank grouped for now into Category II. Risk indicators alter the extent of this relief, which in general is greatest for non-complex firms as new risk indicators identify them. However, the total effect of the new rules for most large banking organizations is to eliminate the hard ceilings that led many companies to

[7] See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

[8] See **CAPITAL224**, *Financial Services Management*, July 17, 2019.

[9] See **INSURANCE60**, *Financial Services Management*, September 17, 2019.

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restrict organic growth and/or to eschew mergers and acquisitions that raised the cost of acquiring smaller companies to the point at which usual merger efficiencies ceased to be persuasive transaction rationales. Companies now have considerably more discretion as to how to grow and with whom to merge based on where they fit in the new categories and whether size or other risk indicators at a target changes these in potentially problematic ways. The nature of several indicators – e.g., size and nonbank assets judged by subsidiaries – also provides scope for non-controlling interests that could provide considerable strategic and technology-innovation opportunities if the FRB finalizes its pending definition of a controlling interest along proposed lines.[10]

What's Next

The FRB adopted the stand-alone and interagency rules at an October 10 FRB meeting at which Gov. Brainard dissented.[11] The FDIC adopted the interagency rule at an October 15 meeting at which FDIC Director Gruenberg dissented. All of these rules are effective sixty days after *Federal Register* publication, with transition periods provided for companies that come under different prudential rules, for SLHCs, and in some cases also for other companies that have not previously come under rules to which they now are subject. Numerous new reporting requirements are also detailed in the rules and phased in over time.

In addition to these rules, the FRB plans at some future date to revise its capital-planning regulations.[12] It will also at some point revise the current definition of a large and complex banking organization. This may address some of the remaining discontinuities between prudential standards liberalized here based on categories and those that still apply to large and complex banking organizations as defined for purposes of subjecting U.S. and foreign banks to horizontal supervision under the Large Institution Supervision Coordinating Committee (LISCC).[13] The agencies also reiterate that they are now considering replacing the advanced-approach risk-based capital rules with a new framework based on the standardized approach to risk-based capital and Basel's final operational risk-based capital rules.[14] No timing for doing so is provided.

Analysis

I. Overall Framework

A. Categories

As noted, non-insurance/non-commercial SLHCs are now covered by the scope of enhanced prudential rules based on the extent to which they fall into the new categories. Covered organizations would determine their category based on relevant indicators averaged over the prior four quarters. Changes take effect on the first day of a calendar quarter following the four quarters in which indicators have changed.

10 See **TAKEOVER8**, *Financial Services Management*, May 3, 2019.

11 See *Client Report* **SIFI33**, October 10, 2019.

12 See **STRESS27**, *Financial Services Management*, February 6, 2017.

13 See **CORPGOV30**, *Financial Services Management*, November 16, 2018.

14 See **OPSRISK20**, *Financial Services Management*, January 8, 2018.

The agencies also plan to monitor quarter-end data versus quarterly averages, reflecting concerns about quarter-end measurements, especially for short-term wholesale funding. Although the agencies retain overall power to alter regulatory standards for individual companies, it rejected comments urging discretionary exemptions to these schedules on grounds that this would undermine transparency.

The size criteria below are judged at the top-tier holding-company level for domestic companies and by CUSO other than with regard to stress-testing and SCCLs. Regulatory capital and liquidity rules are also based on an IHC, not CUSO.

B. Categorization

Subsidiary banks generally fall under the category ascribed to their parent holding company or FBO. With the agencies reserving their authority to impose more stringent standards, categories generally are:

- Category I governs companies designated as U.S. GSIBs. For them, rules are largely unchanged.
- Category II covers U.S. companies and FBOs with more than $700 billion in assets or more than $75 billion in cross-jurisdictional activity that are not U.S. GSIBs.
- Category III applies to domestic companies with over $250 billion in assets and over $75 billion in short-term wholesale funding, nonbank assets, or off-balance sheet assets.
- Category IV covers domestic companies with assets over $100 billion and FBOs with over $100 billion in CUSO that do not meet any of the other standards. Although not Category IV, FBOs over $50 billion in U.S. non-branch assets must still form IHCs and would remain subject to risk-based and leverage capital requirements.

The final rule also provides for lighter-touch regulation for FBOs and IHCs that do not fall into these categories but does not free them from much of their requirements that previously applied to IHCs with assets over $50 billion.[15] FBOs with more than $100 billion in assets but less than $100 billion in CUSO generally meet U.S. standards by demonstrating compliance with home-country requirements. The Board reserves authority to vary FBO standards on a case-by-case basis (i.e., for entities controlled by a foreign government).

C. Risk Indicators

As noted, size that is not adjusted for other indicators remains a key categorization criterion. The final rule also includes several other risk indicators generally set at a ceiling of $75 billion due to the concentration assets at this level would pose at a company with $250 billion in assets. The final rule decides against indexing this or other thresholds on grounds that this would be unduly complex; over time, these thresholds might however be adjusted.

[15] See **FBO3**, *Financial Services Management*, February 25, 2014.

Cross-jurisdictional activity for domestic companies includes all cross-jurisdictional claims and liabilities. For FBOs, it excludes all inter-affiliate claims secured by financial collateral. Global regulators have recently revised the definition of cross-jurisdictional activity for their GSIB standards;[16] the Board expects to make this change at a later date via a separate proposal. Although many commenters suggested changes to this criterion to exclude claims and/or liabilities with various characteristics (e.g., credit insurance), the final rule retains the proposed definition. Any additional changes, to which the Board seems somewhat open, will also be addressed after the final rule has been in place for some time through a separate rulemaking.

Nonbank activities conducted through subsidiaries is the second risk indicator determining categorization. The agencies continue to believe that these activities heighten complexity and funding risk despite comments objecting on grounds that nonbank assets may actually diversify and reduce risk. Commenters also urged deduction of bank-permissible activities from the nonbank measure since many (e.g., broker-dealers) are long standing. The final rule retains the measurement as proposed on grounds that it is an accurate, simple proxy for operational complexity and that nonbank risk has long been associated with banking. Nonbank assets may be held in insured-depository subsidiaries that do not count for purposes of measuring nonbank activities.

Off-balance sheet exposure remains a risk-based indicator on grounds that it supplements the basic size indicator. The measurement as proposed was particularly problematic to FBOs due to inclusion in it of inter-affiliate transactions, but the final rule retains it on grounds that these exposures pose risk due to complexity and opacity.

Another risk-based indicator is based on weighted short-term wholesale funding. These funds include funding from wholesale counterparties (including Federal Home Loan Banks) and certain brokered deposits and sweep accounts weighted according to factors such as maturity. Many industry commenters opposed aspects of this indicator, with FBOs in particular countering that it disproportionately affected FBO capital-markets activity and thus their competitiveness. Domestic banks also protested the indicator and/or its methodology on grounds that this risk is captured by the liquidity coverage ratio[17] and the proposed net stable funding ratio.[18] However, as in the GSIB-surcharge rule, the FRB reiterates that these rules do not capture systemic risk which the tailoring rule must now do for non-GSIBs. The final rule thus retains the proposed approach.

II. Applicable Regulations

The final rule continues to vary regulatory requirements based on the category into which a banking organization falls based on the risk indicators described above. However, the final rule does alter the proposed approach for FBOs, focusing on the risk based on CUSO, not that of a parent bank.

[16] See **GSIB13**, *Financial Services Management*, July 23, 2018.

[17] See **LIQUIDITY17**, *Financial Services Management*, October 1, 2014.

[18] See **LIQUIDITY26**, *Financial Services Management*, May 5, 2016.

A. Capital

Consistent with the framework above, GSIBs and their depository institution subsidiaries remain under advanced-approach capital rules,[19] the enhanced supplementary leverage ratio,[20] the counter-cyclical capital buffer when triggered,[21] and the U.S. GSIB surcharge.[22] FBOs are not covered in Category I rules even if their parent company is a designated GSIB. AOCI recognition remains mandatory.

Category II companies fall under the advanced approach (including mandatory AOCI recognition), the counter-cyclical capital buffer if triggered, and the supplementary leverage ratio[23] (which did not previously apply to the only company now so designated). Should any IHC come into Category II, it could remain under the SA.

Category III companies, IHCs, and their bank subsidiaries now may use the SA risk-based capital rules with optional AOCI recognition, the supplementary leverage buffer, and the counter-cyclical capital buffer. As noted, they now also enjoy relief on MSAs and other assets not address in the initial proposal. If the U.S. advances pending changes to the SA for counterparty credit risk (SA-CCR), then Category III companies could also elect to use it.

Category IV companies come under the SA and the generally-applicable leverage ratio (ranging from three to five percent). This provides considerable capital relief to these companies even though most were already under the SA.

B. Stress Testing

1. Mid-Cycle Tests

These are now eliminated for all large banking organizations, although the FRB retains the authority to demand it.

2. Qualitative Objections

The right of the Fed qualitatively to object to stress-test results has been eliminated for most domestic companies and is now eliminated for all large banking organizations that successfully passed their fourth-year tests under the capital-plan rule. The qualitative objection has been temporarily retained for IHCs and other firms just coming under U.S. stress-test requirements.

Category III companies must continue to provide an annual capital plan in concert

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19 See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

20 See **LEVERAGE6**, *Financial Services Management*, April 14,2014.

21 See **CAPITAL213**, *Financial Services Management*, September 15, 2016.

22 See **GSIB7**, *Financial Services Management*, July 23, 2015.

23 See **LEVERAGE,** *Financial Services Management*, July 16, 2013.

with internal stress testing and reporting, with the Board annually reporting its own stress-test results for these companies even though their disclosure cycle is now biennial.

Category IV companies are now subject only to biannual supervisory stress testing, with the rule eliminating the current requirement also for annual company-run tests and related disclosures. However, certain reporting requirements remain. The Board also retains the authority to mandate more frequent stress tests for Category IV companies. The forthcoming capital-planning rule mentioned above will address implementation aspects of the new reporting system.

3. *Scenarios*

The adverse scenario is removed.

C. Liquidity Standards

1. *General Changes*

As noted, the proposals would have evaluated FBO liquidity risk based on CUSO. Comments objected on competitiveness, national treatment, and burden grounds. The agencies concurred. As a result, FBO liquidity risk for purposes of the standards described below will be assessed only at IHCs.

2. *Enhanced Liquidity Standards*

For purposes of the enhanced liquidity rules discussed below, HQLAs are now defined as in the LCR standards. The LCR rule's operational requirements also apply.

As proposed, U.S. GSIBs must now report certain liquidity data each business day. Also, as proposed, Category II companies join GSIBs in the enhanced liquidity risk rules now liberalized for other banking organizations.[24] These rules and stress testing along with daily reporting apply at the top tier of a U.S. company and for each FBO's IHC, CUSO, and branches and agencies.

Category III companies at the same levels are now required to report monthly liquidity data or, if the company has more than $75 billion in wholesale short-term funds, do so on a daily basis. Category III companies are also subject to the enhanced liquidity-risk standards described above.

Category IV companies come under a less onerous set of liquidity standards (e.g., stress testing is quarterly, not monthly). Fewer reporting and governance elements also apply.

3. *LCR*

IHCs will be subject to the full or modified LCR based on how they fall into the categories described below, with these rules also applicable as appropriate to depository institution subsidiaries:

24 See **LIQUIDITY15**, *Financial Services Management*, February 27, 2014.

- Category I and II companies remain or come under the full LCR.
- Category III requirements depend on a company's short-term wholesale funding. Those with this funding of $75 billion or more come under the full LCR; those without this exposure must comply with 85 percent of the full LCR's requirements.
- Category IV requirements are seventy percent of the full LCR.

Regardless of category, all banking organizations must now include a maturity mis-match add-on when calculating their LCRs.

4. *Net Stable Funding Ratio*

Although the U.S. has not yet finalized its NSFR proposal,[25] the LCR framework above will apply based on categories when it does.

D. Single-Counterparty Credit Limits (SCCLs)

SCCLs now apply only to Category I, II, and III companies, with FBOs allowed to demonstrate compliance if their parent companies adhere to Basel's credit-exposure limits.[26] IHCs that fall into Categories II and III are also subject to SCCLs with transition periods provided to ensure compliance over time. Category IV subsidiaries of FBOs no longer come under SCCLs.

E. Risk Management and Risk Committees

Risk-committee requirements are adjusted as required by EGRRCPA so that thresholds now generally rise to $50 billion for risk-management and risk-committee purposes, not $10 billion. FBO thresholds also rise to $50 billion for risk-committee purposes, U.S. risk-officer and related management requirements continue to apply at prior $50 billion thresholds.

25 See **LIQUIDITY26**, *Financial Services Management*, May 5, 2016.

26 See **CONCENTRATION5**, *Financial Services Management*, April 23, 2014.

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