Financial Services Management

Large Financial Institution Supervisory Ratings

Cite

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Impact Assessment

- The impact of the new rating system is uncertain in the absence of parallel FRB early-intermediation requirements.
- FRB ratings for large BHCs, IHCs, and certain S&LHCs would now reflect CCAR, CLAR, pending governance requirements. Quantitative compliance with underlying capital and liquidity rules will apparently be less important, reinforcing stress-test requirements as *de facto* binding constraints.
- The FRB's corporate-governance rules would become the minimum against which subsidiary banks are judged regardless of applicable primary-regulatory standards.
- Although these governance standards were proposed only as guidance, formal incorporation of them into ratings makes them *de facto* rules. This may prove particularly challenging for IHCs left out of the guidance on grounds that applying it to them raises complex governance challenges.

Overview

The FRB has proposed an overhaul to its supervisory ratings of large financial institutions – essentially a specialized CAMELS standard focused on the biggest BHCs and other companies under the FRB's jurisdiction. However, unlike CAMELS and the current BHC-rating system, a composite rating would not apply; instead, the FRB would judge covered companies' capital planning and adequacy, liquidity-risk management and adequacy,

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and governance without combining these judgments into an overall safety-and-soundness conclusion. The governance rating would be based on the supervisory guidance for large institutions proposed in tandem with these ratings,[1] with the capital and liquidity components now judged to a considerable extent on the performance of a covered company and its U.S. operations under FRB stress-test standards.

Impact

In the wake of the financial crisis, the FRB tightened many aspects of its rules for and its supervision of large financial institutions (LFIs) under its authority. It did not, however, modify the way it has judged the largest BHCs since 2004 when it established the "RFI" system for all BHCs, not just large ones. It took over S&LHC supervision in 2008 and has since used the RFI approach for them on an "indicative" basis without developing a more modern approach. It also plans to use the new LFI system for the intermediate holding companies (IHCs) established since the crisis for foreign banking organizations.[2] Other BHCs would remain under the older RFI approach.

Unlike the current system, the Board does not intend to impose a composite new rating for LFI because it believes that each of the three component issues to be assessed are sufficiently clear and relevant to safety and soundness in their own right to guide both LFIs and their supervisors. However, a blended rating could better reflect how an LFI manages the trade-offs among different requirements to arrive at a company that is on an aggregate basis satisfactory or even outstanding from a prudential perspective. For example, there is a trade-off between capital adequacy and ample liquidity because of the leverage capital requirement applicable to the high-quality liquid assets required by the liquidity rules. A large BHC that relies on short-term wholesale funding thus requires more capital than similar-sized BHCs with different funding models. Looking at capital and liquidity holistically illuminates the extent to which liquidity is indeed ample or if the need to ensure capital adequacy has led the BHC to short-change the liquidity coverage ratio.

However, judging each component on its own could protect the FRB from rating challenges. Recent litigation has challenged CAMELS on grounds that subjective judgements about managerial capacity ("M") and earnings ("E") have led to significant downgrades despite strong capital adequacy, liquidity, and risk sensitivity. So far, the court has found that a small bank may protest actions based on downgrades of any of the CAMELS factors other than the C for capital. The LFI rating approach includes what some may believe to be subjective factors, especially with regard to corporate governance, but the lack of a composite final rating ensures that each

[1] See **CORPGOV23**, *Financial Services Management*, August 8, 2017.
[2] See **FBO3**, *Financial Services Management*, February 25, 2014.

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component stands on its own and thus may not be subject to challenge based on more quantitative criteria should the courts uphold the bank challenge against CAMELS.

The proposed approach raises questions about the extent to which the Board will rely on the quantitative capital and liquidity measures on which CAMELS and the current BHC approach now rely. It appears to be more focused on stress-test than regulatory performance. This will make the rating system more flexible in the wake of emerging stresses and idiosyncratic institutional factors than CAMELS, but also increase uncertainty given the more subjective nature of the capital-planning and stress-test standards.[3] The focus on capital planning may also reverse the qualitative relief recently granted by the FRB to BHCs with assets of less than $250 billion.[4]

The ratings components and scale are described in more detail below. In sharp contrast to the current CAMELS and BHC approach, the FRB does not expect what is equivalent to a 2 or, to a lesser degree high-3 rating to be granted for more than a short time period (i.e., eighteen months). This is in sharp contrast to post-crisis CAMELS ratings which now include virtually no 1-rated banks and in which a 2-rating has been the norm for years. The approach would make it easier for large BHCs to achieve high ratings on at least one component. It might also prevent the practice that prevailed prior to 2008, when banks and BHCs received increasingly-substandard CAMELS without meaningful prompt corrective action.

However, what the FRB might in fact do when ratings are unsatisfactory is not made clear in this NPR. Although the NPR discusses factors the Board would consider when moving a BHC up or down the new scale, the broader scope of supervisory actions is neither described nor clear in current rules. The FRB has yet to issue a final version of the early-remediation standards required by Dodd-Frank[5] which are meant to trigger corrective action when risk indicators such as those in these ratings are observed.

The new parent-company rating system would as noted apply to IHCs, with the Board's questions also exploring the extent to which they should apply more broadly to foreign banks under its authority. As the question notes, rating foreign banks is complicated by the different standards under which parent companies are governed and home-country laws that often differ markedly from U.S. prudential and investor-protection standards. The FRB for these reasons exempted IHCs from the corporate governance guidance. However, by subjecting them to the rating system and given the importance of this component, IHCs are at significant risk of major

[3] See *Client Reports* in the **STRESS** series.

[4] See **STRESS27**, Financial Services Management, February 6, 2017.

[5] See **SYSTEMIC55**, *Financial Services Management*, January 18, 2012.

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downgrades on at least one of the three rating factors. For them as for other covered firms, it is unclear what would happen then, but it is surely not an event without adverse consequence. U.S. covered companies would also likely have to increase their focus on governance regardless of the extent to which they believe they complied with the guidance because, enacted in virtually identical fashion in a parallel rule, the governance guidance in fact has specific force of rule and law.

This along with the stress-test approach of the rating system could be particularly challenging for BHCs and other companies with major subsidiaries (i.e., lead banks) under the OCC or FDIC. For example, the corporate-governance guidance applies to state member banks, but large national banks are under different OCC standards.[6] The Board indicates that it will consult with primary regulators and perhaps also defer to them, but its ratings doubtless will nonetheless reflect FRB standards and judgments, not those of primary supervisors. This may result in duplicative compliance and governance standards and even *de facto* FRB governance of capital, liquidity, and governance for bank subsidiaries. Again, the question of what enforcement penalties will result from rating downgrades creates uncertainty about the importance of differences between Board and primary-agency standards.

Interestingly, one of the questions on which the Board seeks comment is the extent to which rating transparency should be increased. As with CAMELS and its current BHC-rating system, this NPR stipulates that the LFI approach would be strictly confidential. Former FRB Gov. Tarullo had suggested before his resignation that supervisory ratings be made more transparent to enhance market discipline. An op-ed from Karen Petrou had earlier argued for transparency not only on this ground, but also to enhance supervisory accountability.

What's Next

The Board proposed this ratings system on August 3; comments will be due sixty days after publication in the *Federal Register*. The new approach is to apply in 2018. The short phase-in schedule is proposed because the Board expects the switch between the current BHC rating (akin to CAMELS) and the new one to be "routine" for most covered companies. Initially, all covered companies will receive ratings on each component together; thereafter, rating cycles for different components are likely to vary.

[6] See **RISKMANAGEMENT11**, *Financial Services Management*, September 16, 2014.

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Analysis

A. Scope

Although the Board reserves its right to impose the new system on other firms, it would generally apply to:

- all BHCs with assets over $50 billion;
- all non-insurance, non-commercial S&LHCs with assets over $50 billion. To date, these companies have only had the FRB's ratings applied to them on an "indicative" basis; and
- IHCs.

References to the board below also apply to board committees.

B. LFI Rating Components

These would be:

- capital planning and position. This covers how capital is determined under a range of stress conditions and capital adequacy sufficient to ensure both compliance with applicable rules and resilience under stress. As noted, CCAR would be the principal criterion for this component. Under the current system, capital is considered only with regard to its adequacy in terms of an organization's consolidated capital position. It considers relevant market indicators (e.g., external debt ratings, credit spreads, debt and equity prices) but not CCAR (which did not exist in 2004);
- liquidity-risk management and position. This would assess liquidity planning under an array of conditions, judged by horizontal review of "several firms assumed to be comparable under the Comprehensive Liquidity Analysis and Review (CLAR) process" and at the LFI itself to ensure liquidity compliance, adequacy, and resilience. Liquidity under the current system reflects only the consolidated organization's ability to attract and maintain the sources of funds necessary to support operations and meet obligations. CLAR is not considered under the current system (again it did not exist in 2004); and
- Governance and controls. As noted, these would be judged by the new guidance, which is not yet applicable to IHCs. LFIs would also be judged by their ability to align strategic objectives with risk tolerance and risk-management (including internal audit). Consumer compliance fits in here and domestic GSIBs would also be judged for their recovery and resolution

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plans. Other covered companies could come under this additional component should the FRB decide to propose it in a formal rulemaking.

C. Ratings Scale

This would be:

- satisfactory;
- satisfactory watch;
- deficient-1; and
- deficient-2.

These ratings for each component would be on a consolidated group-wide basis including “critical operations” and “banking offices.”

D. Request for Comment

Views are specifically sought on:

- additional rating criteria;
- expectation and coverage clarity;
- clarity on the role of senior management;
- the terms and timing of the supervisory-watch rating and its value as a motive for rapid remediation;
- the benefit of adding resolution planning as a rating component. If so, in what way;
- transparency enhancements; and
- the best way to integrate ratings for foreign banking organizations.

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