Memorandum

Federal Reserve Proposes Enhanced Prudential Standards and Early Remediation Requirements

January 11, 2012

Moving forward on what many consider to be the most important and most significant part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), on Dec. 20, 2011 the Board of Governors of the Federal Reserve System ("Board") proposed rules (the "Proposed Regulation") to impose greater regulation and supervision on:

- U.S. bank holding companies ("BHCs") with $50 billion or more in consolidated assets; and
- Non-bank financial companies (U.S. and non-U.S.) designated as "systemically important" by the Financial Stability Oversight Council ("Council")

(collectively, "Covered Companies").[1] This *Memorandum* summarizes the Proposed Regulation. Interested parties have until March 31, 2012 to submit comments to the Board (including in response to the 95 explicit questions asked by the Board).

I. Executive Summary

The Proposed Regulation implements Sections 165 and 166 of the Dodd-Frank Act, which require the Board to develop and adopt enhanced prudential standards for systemically important financial institutions ("SIFIs") and procedures for the early remediation of financial distress at a SIFI. However, as noted above, the Proposed Regulation does not apply to all SIFIs. In general, it would not apply to SIFIs that are foreign banking organizations ("FBOs") or U.S. savings and loan holding companies ("SLHCs"), as the Board opted to postpone rulemaking governing such entities.[2]

The Proposed Regulation's enhanced prudential standards include:

- Risk-based capital and leverage requirements;
- Liquidity requirements;

[1] The Proposed Regulation is available at http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm.

[2] However, SLHCs are subject to the Proposed Regulation's company-run stress testing requirements (which apply once the Board has established risk-based capital requirements for SLHCs). Moreover, an FBO's U.S.-based bank holding company subsidiary that, on its own, has total consolidated assets of $50 billion or more would, itself, be a Covered Company. With the exception of the proposed liquidity and enterprise-wide risk management requirements and the debt-to equity limit for Covered Companies that the Council has determined pose a grave threat, the proposed rule would not apply to any bank holding company subsidiary of a foreign banking organization that has relied on Supervision and Regulation Letter SR 01–01 issued by the Board of Governors (as in effect on May 19, 2010) until July 21, 2015.

- Single-counterparty exposure limits;
- Risk management and risk committee requirements;
- Stress test requirements; and
- A debt-to-equity limit for certain Covered Companies that the Council has determined pose a grave threat to financial stability.

On its face, the Proposed Regulation would apply these standards equally to all Covered Companies, whether BHCs or non-banks. However, the Board has indicated that it will tailor the application of the standards (on an individual basis or by category), taking into consideration the company's size, capital structure, complexity, activities and any other risk-related factor the Board deems appropriate.

The Proposed Regulation would also establish a regime whereby a Covered Company that exhibits signs of financial distress or risk-management weakness could be subject to remedial action by the Board. This regime consists of four remediation levels, which increase in stringency as the financial condition of a Covered Company deteriorates and could, ultimately, result in a recommendation that the company be placed into resolution under Title II of the Dodd-Frank Act.

II. Risk-Based Capital and Leverage Limits

These requirements will be implemented in two phases. In the first phase, all Covered Companies, whether BHCs or non-banks, must comply with, and hold capital commensurate with, the requirements of any regulations adopted by the Board relating to capital plans and stress tests, including the rule adopted on Dec. 1, 2011 ("Capital Plan Rule").[3] In addition, a non-bank Covered Company must comply with the same minimum risk-based and leverage capital requirements that apply to BHCs (i.e., a minimum Tier 1 risk-based capital ratio of four percent, a minimum total risk-based capital ratio of eight percent and a minimum Tier 1 leverage ratio of four percent) within 180 days of becoming a Covered Company.

In the second phase, the Board will issue a proposal to implement a risk-based capital surcharge based on the framework and methodology developed by the Basel Committee on Banking Supervision ("BCBS"). The Board contemplates adopting implementing rules in 2014, and requiring "global systemically important banks" ("G-SIBs")[4] to meet the capital surcharges, discussed below, on a phased-in basis from 2016-2019.

Capital Planning and Minimum Capital Requirements

Pursuant to the Capital Plan Rule, Covered Companies must have robust, forward-looking capital planning processes that account for their unique risks and that permit continued operations during times of economic and financial stress.[5] A Covered Company is required to submit an annual "capital plan" (approved by its board of directors) covering a minimum nine-quarter, forward-looking planning horizon, in which the company:

- Demonstrates the ability to satisfy applicable risk-based and leverage capital ratios under both baseline and stressed conditions;
- Discusses its sources and uses of capital reflecting its risk profile;

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[3] 12 C.F.R. 225.8. A non-bank Covered Company would become subject to the requirements of the Capital Plan Rule on Sept. 30 of the year it became a Covered Company, unless it became a Covered Company less than 180 days before Sept. 30, in which case it would need to comply by the following year.

[4] *See* Basel Committee on Banking Supervision, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (Nov. 2011), *available at* http://www.bis.org/publ/bcbs207.htm.

[5] The supervisory and company-run stress tests included in the Proposed Regulation are aspects of the forward-looking process. The Board expects that a Covered Company will integrate into its capital plan, as one part of the underlying analysis, the results of the company-run stress tests conducted in accordance with Section 165(i)(2) of the Dodd-Frank Act and the Board's proposed implementing rules. In June 2011, the Board, along with the OCC and the FDIC, issued for comment proposed supervisory guidance on stress testing for banking organizations with more than $10 billion in total assets. 76 F.R. 35,072 (June 15, 2011). The proposed stress testing framework includes capital and liquidity stress testing.

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- Demonstrates the ability to maintain a minimum "Tier 1 Common" [6] risk-based capital ratio of five percent under both baseline and stressed conditions;
- Describes all planned capital actions over the planning horizon; and
- Describes, in detail, its process for assessing capital adequacy.

A Covered Company that is unable to satisfy these requirements generally may not make any capital distributions until it provides a satisfactory capital plan to the Board. In addition, a Covered Company must obtain prior approval from the Board before making a capital distribution, if such distribution would constitute a material change from the capital plan or occurs while the Board is reviewing the plan.

Quantitative Risk-Based Capital Surcharge
As noted above, the Board intends to implement a quantitative risk-based capital surcharge for Covered Companies, or a subset thereof, based on the BCBS approach. The recently finalized BCBS framework requires G-SIBs to hold an additional amount of common equity above the regulatory minimums, and establishes five capital surcharge categories, ranging from 100 to 350 basis points, allocating G-SIBs to a specific surcharge category based on a 12-factor formula. The formula includes measures of size, interconnectedness, complexity, lack of substitutes and cross-border activity. The capital surcharge must be met with common equity only.

III. Liquidity Requirements

These measures would also be implemented in multiple phases. In the first phase, Covered Companies would be subject to *qualitative* liquidity risk-management standards, based on the liquidity risk-management guidance jointly issued by the Board and other federal banking regulators in March 2010, which generally requires companies to conduct internal liquidity stress tests and set internal quantitative limits to manage liquidity risk.[7] Covered Companies are also required to generate comprehensive cash flow projections, to establish and monitor its liquidity risk tolerance, and maintain a contingency funding plan ("CFP") that identifies potential sources of liquidity strain and alternative sources of funding.

In the second phase, the Board would implement *quantitative* liquidity requirements, through one or more future Board proposals based on the framework and methodology developed by the BCBS.[8]

Corporate Governance Provisions
Under the Proposed Regulation, a Covered Company's board of directors are charged with:

- Annually establishing the company's liquidity risk tolerance (defined as the acceptable level of liquidity risk the Covered Company may assume in connection with its operating strategies) and semi-annually reviewing compliance with such tolerance;[9] and
- Reviewing and approving the CFP at least annually and whenever the Covered Company materially revises the plan.

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[6] Under the Capital Plan Rule, Tier 1 Common is defined as Tier 1 capital less non-common elements in Tier 1 capital, including perpetual preferred stock and related surplus, minority interest in subsidiaries, trust preferred securities and mandatory convertible preferred securities.

[7] 75 F.R. 13,656 (March 22, 2011).

[8] The quantitative liquidity requirements established by the BCBS include two ratios: (1) a liquidity coverage ratio ("LCR"), designed to promote the short-term resiliency of an entity's liquidity risk profile by ensuring that it has sufficient high-quality liquid resources to survive an acute stress scenario lasting for one month; and (2) a net stable funding ratio ("NSFR"), designed to promote liquidity risk resilience over a one-year period and to create incentives for an entity to fund its activities with medium- and longer-term funding sources. Under Basel III, the LCR and NSFR are to be implemented by BCBS members by 2015 and 2018, respectively.

[9] The board of directors would be required to consider the Covered Company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors to ensure that the established liquidity risk tolerance will be appropriate for its business strategy and its role in the financial system, and will reflect its financial condition and funding capacity on an ongoing basis.

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In addition, the board of director's risk committee (discussed below) is responsible for:

- Reviewing each significant business line or product for compliance with the company's liquidity risk tolerance, at least annually;
- Reviewing and approving the liquidity costs, benefits and risk of each significant new business line or product in advance;
- On at least a quarterly basis:
  - Reviewing the required comprehensive cash flow projections (discussed below) that cover time periods in excess of 30 days to ensure liquidity risk tolerance compliance;
  - Reviewing and approving the required liquidity stress testing (discussed below), including testing practices, methodologies and assumptions (including pre-approving any material changes to the company's liquidity stress testing);
  - Reviewing the results of such liquidity stress testing results;
  - Approving of the size and composition of the required liquidity buffer (discussed below);
  - Reviewing and approving the required specific limits on potential sources of liquidity risk (discussed below), and reviewing the Covered Company's compliance with those limits;
  - Reviewing liquidity risk management information necessary to identify, measure, monitor and control liquidity risk and to comply with the Proposed Regulation;
- Periodically reviewing the required independent validation of the stress tests (discussed below); and
- Establishing procedures governing the content of senior management reports relating to liquidity risk.

Under the Proposed Regulation, senior management responsibilities include:

- Establishing and implementing liquidity risk management strategies, policies and procedures;
- Overseeing the development and implementation of the liquidity risk measurement and reporting systems, cash flow projections, liquidity stress testing, liquidity buffer, CFP, specific limits and monitoring procedures required by the Proposed Regulation (as discussed below); and
- Reporting regularly to the risk committee or designated subcommittee thereof on the company's liquidity risk profile and providing all other necessary information to the board of directors (or risk committee) to facilitate its oversight of the liquidity risk management process.

A Covered Company would also be required to establish a review process, independent of the management personnel or structures that execute funding (e.g., treasury), that:

- At least annually, evaluates the adequacy and effectiveness of the company's liquidity risk management processes, including adherence to its policies and procedures and adequacy of its risk identification, measurement and reporting processes;
- Assesses whether the company's liquidity risk management complies with applicable law and sound business practices; and
- Reports any legal noncompliance and other material liquidity risk management issues to the board of directors (or the risk committee) in writing for corrective action.

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Cash Flow Projections
The Proposed Regulation requires a Covered Company to produce comprehensive projections that forecast cash flows arising from assets, liabilities and off-balance sheet exposures over appropriate short- and long-term time periods,[10] and to identify and quantify mismatches over these time periods. Short-term cash flow projections must be updated daily, and long-term projections updated at least monthly. Such projections must:

- Include cash flows arising from contractual maturities, as well as from new business, funding renewals, customer options and other potential events that may impact liquidity;
- Provide sufficient detail in relation to the company's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors;
- Be based on a robust methodology, using reasonable assumptions; and
- Be reviewed and approved by senior management on a periodic basis.

Liquidity Stress Testing
The Proposed Regulation requires a Covered Company to regularly (at least monthly[11]) stress test its cash flow projections by identifying liquidity stress scenarios and assessing the effects of these scenarios on its cash flow and liquidity. The results must be used to determine the size of the company's liquidity buffer and incorporated into the quantitative component of its CFP. The Proposed Regulation requires that such liquidity stress testing:

- Uses reasonably high-quality data and information to produce creditable outcomes;
- Comprehensively addresses a company's full activities, exposures and risks, including off-balance sheet exposures;[12]
- Incorporates a range of stress scenarios that may significantly affect the company's liquidity, taking into consideration its on- and off-balance sheet exposures, business lines, organizational structure and other characteristics;
- Incorporates stress scenarios to account for market stress, idiosyncratic stress and combined market and idiosyncratic stresses;
- Incorporates stress scenarios that address the potential impact of market disruptions on the company, and the potential actions of other market participants experiencing the same disruption;
- Is forward-looking and incorporate a range of potential changes to the company's exposures, activities and risks, as well as changes to the broader economic and financial environment;[13]
- Employ a variety of time horizons to adequately capture rapidly developing events and conditions that may materialize over a longer period (including, at a minimum, an overnight, a 30-day, a 90-day and a one-year time horizon);
- Uses sources of funding that are sufficiently diversified throughout each stress test time horizon; and
- Be tailored to, and provide sufficient detail to reflect the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.

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[10] Appropriate given its capital structure, risk profile, complexity, activities, size and other risk-related factors.

[11] The Board may require a company to perform additional stress testing as conditions warrant or to address supervisory concerns.

[12] For example, stress testing should address potential liquidity issues arising from the company's use of sponsored vehicles that issue debt instruments to the markets. Under stress scenarios, the company may be contractually required, or compelled in the interest of mitigating reputational risk, to provide liquidity support to such a vehicle.

[13] To meet this standard, the stress tests would need to be sufficiently dynamic to incorporate changes that may arise from idiosyncratic events or macroeconomic or market developments, or some combination thereof.

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The stress tests must also be based on certain assumptions, including:

- For the first 30 days of a liquidity stress scenario, only “highly liquid assets”[14] that are “unencumbered”[15] may be used to meet projected funding needs; and
- The fair market value of assets used as a cash flow source to offset projected funding needs must be discounted to reflect any credit risk and market volatility of the asset.

The Proposed Regulation imposes various process and system requirements for stress testing, such as requiring Covered Companies to:

- Establish and maintain policies and procedures that outline its liquidity stress testing practices, methodologies and assumptions (and periodically update the same to reflect changing risks and evolving techniques);
- Maintain management information systems and data processes sufficient to enable it to effectively and reliably collect, sort and aggregate data and other information related to liquidity stress testing; and
- Maintain a compliance system to ensure that each stress test is designed and conducted in accordance with the Proposed Regulation.

Liquidity Buffer

The Proposed Regulation requires a Covered Company to continuously maintain a liquidity buffer of unencumbered, highly liquid assets (defined above) sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days during a range of liquidity stress scenarios. The size of a company’s liquidity buffer is determined by the results of its liquidity stress testing, as well as its liquidity risk tolerance, capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.

The pool of assets included in the liquidity buffer must be sufficiently diversified by instrument type, counterparties, geographic market and other liquidity risk identifiers. Moreover, the fair market value of any asset included in the liquidity buffer must be discounted to reflect its credit risk and market volatility.

Contingency Funding Plan

The Proposed Regulation requires Covered Companies to establish and maintain a CFP (updated at least annually), which:

- Incorporates information generated by liquidity stress testing to:
  - Identify events that would have a significant impact on the company’s liquidity;
  - Assess the potential level and nature of the impact of such events;
  - Assess available funding sources and needs during such events; and
  - Identify alternative funding sources available during such events;
- Establishes procedures for managing liquidity during identified liquidity stress events, including:
  - An action plan clearly describing strategies the company would use to respond to liquidity shortfalls;
  - The identity of a liquidity stress event management team;

[14] Defined as cash, securities issued by the U.S. government or a U.S. agency or government-sponsored entity, or any other asset that, to the satisfaction of the Board: (1) has a low credit and market risk; (2) is traded in an active, large and liquid secondary market; and (3) is the kind of asset historically purchased in times of market distress. The Board has indicated that “plain vanilla” corporate bonds could, potentially, satisfy these criteria.

[15] To be unencumbered, an asset must not be: (1) pledged; (2) used to secure, collateralize or provide credit enhancement to any transaction; or (3) designated as a hedge on a trading position; or subject to any legal or contractual restrictions on its sale, transfer, assignment or liquidation, as applicable.

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- The processes for invoking the CFP, decision-making during identified liquidity stress events, and executing contingency measures identified in the action plan; and
  - A mechanism that ensures effective internal and external reporting and communication during identified liquidity stress events;
- Includes procedures for monitoring emerging liquidity stress events based on early warning indicators that are tailored to the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.[16]

A Covered Company would be required periodically to test its CFP to assess its reliability during liquidity stress events. Such testing would include trial runs of the methods to access alternate funding, and operational elements of the CFP.

Specific Limits
The Proposed Regulation requires a Covered Company to establish and maintain limits on potential sources of liquidity risk, including:

- Concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding and other liquidity risk identifiers;
- The amount of specified liabilities that mature within various time horizons; and
- Off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.[17]

The size of each limit must reflect the company's established liquidity risk tolerance, capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors.

Monitoring
The Proposed Regulation requires a Covered Company to establish and maintain procedures to:

- Monitor collateral, including:
  - Calculating all of its collateral positions in a timely manner, including the value of assets pledged relative to the amount of security required under the relevant contract, and the unencumbered assets available to be pledged;
  - Monitoring the levels of available collateral by legal entity, jurisdiction and currency exposure;
  - Monitoring shifts between intraday, overnight and term pledging of collateral; and
  - Tracking operational and timing requirements associated with accessing collateral at its physical location;
- Monitor legal entities, business lines and currencies, including:
  - Monitoring and controlling liquidity risk exposures and funding needs within and across significant legal entities, currencies and business lines; and
  - Maintaining sufficient liquidity with respect to each significant legal entity in light of legal and regulatory restrictions on the transfer of liquidity between legal entities; and
- Monitor intraday liquidity positions, including:
  - Monitoring and measuring expected daily gross liquidity inflows and outflows;

[16] Such early warning indicators may include, but are not limited to, negative publicity concerning an asset class owned by the company, potential deterioration in its financial condition, widening debt or credit default swap spreads, and increased concerns over the funding of off-balance-sheet items.

[17] Such exposures may be contractual or non-contractual exposures, and include such liabilities as unfunded loan commitments, lines of credit supporting asset sales or securitizations, collateral requirements for derivative transactions and a letter of credit supporting a variable demand note.

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- Managing and transferring collateral when necessary to obtain intraday credit;
  - Identifying and prioritizing time-specific obligations so that they can be met as expected;
  - Settling less critical obligations as soon as possible;
  - Controlling the issuance of credit to customers where necessary; and
  - Considering the amounts of collateral and liquidity needed to meet payment systems obligations when assessing overall liquidity needs.
- Monitor compliance with the specific limits on sources of liquidity risk discussed above.

Documentation
The Proposed Regulation requires a Covered Company to adequately document all material aspects of its liquidity risk management processes and its compliance with the requirements of the Proposed Regulation, and submit such documentation to its risk committee. The Covered Company must make this documentation available to the Board upon request.

IV. Single-Counterparty Exposure Limits[18]

The Proposed Regulation limits the exposure that any Covered Company and its "subsidiaries"[19] may have, on a consolidated basis, to any single counterparty and its subsidiaries, with a more stringent single-counterparty credit limit applied to exposures between "Major Covered Companies" as defined below (respectively, the "General Limit" and the "Major Company Limit").[20] A Covered Company must comply with the limits on a daily basis at of the end of each business day and must submit a monthly compliance report.

General Limit
Under the General Limit a Covered Company, together with its subsidiaries, may not have an aggregate net credit exposure to any single unaffiliated counterparty, together with its subsidiaries, in excess of 25 percent of the Covered Company's capital stock and surplus.

Major Company Limit
The Major Company Limit would apply to exposure between:

- Any BHC Covered Company with total consolidated assets of $500 billion or more or *any* non-bank Covered Company (each, a "Major Covered Company"); and
- Another Major Covered Company or a foreign banking organization that is or is treated as a bank holding company and that has total consolidated assets of $500 billion or more (each, a "Major Counterparty").

Under the Major Company Limit, a Major Covered Company, together with its subsidiaries, may not have an aggregate net credit exposure to any single unaffiliated Major Counterparty, together with its subsidiaries, in excess of 10 percent of the Major Covered Company's capital stock and surplus.

[18] This subpart of the Proposed Regulation implements Section 165(e) of the Dodd-Frank Act, which is a separate and independent limit from the investment securities limits and lending limits in the National Bank Act. A Covered Company must comply with all of the limits that are applicable to it and its subsidiaries.

[19] Defined to include any entity "controlled" by the Covered Company. For this purpose, "control" exists when a Covered Company directly or indirectly owns or controls 25 percent or more of a class of a company's voting securities or 25 percent or more of a company's total equity, or consolidates the company for financial reporting purposes.

[20] A company that is a Covered Company on the effective date of this subpart (or becomes so prior to before Sept. 30, 2012) must comply with the single-counterparty exposure limits beginning on Oct. 1, 2013. A company that becomes a Covered Company after Sept. 30, 2012 must comply with the limits beginning on the first day of the fifth quarter following the date on which it became a Covered Company.

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Exemptions
The Proposed Regulation exempts from the definition of the term "credit exposure":

- Obligations, or portions thereof, directly and fully guaranteed as to principal and interest by the U.S. government, a U.S. agency, or Fannie Mae or Freddie Mac (while they are under the conservatorship or receivership of the Federal Housing Finance Agency);
- Intraday credit exposure to a counterparty; and
- Any other transaction determined by the Board.

Calculating Capital Stock and Surplus
Under the Proposed Regulation, "capital stock and surplus" of a Covered Company is the sum of: (1) its total regulatory capital; and (2) the balance of its allowance for loan and lease losses not included in Tier 2 capital[21] in the case of a BHC, as reported on its most recent Form FR Y-9C and, in the case of a non-bank Covered Company, as reported in its most recent regulatory report to the Board.

Calculating Aggregate Net Credit Exposure
Under the Proposed Regulation, "Aggregate net credit exposure" is defined to mean the sum of all "net credit exposures" of a Covered Company to a single counterparty.

- "Net credit exposure" is defined to mean, with respect to any "credit transaction," the "gross credit exposure" of a Covered Company, adjusting for the effect of qualifying master netting agreements, eligible collateral, eligible guarantees, eligible credit derivatives and eligible equity derivative hedges, and other eligible hedges (i.e., a short position in the counterparty's debt or equity security).
- "Credit transaction" is defined as, with respect to any counterparty, any:
  - Extension of credit to the counterparty, including loans, deposits and lines of credit, but excluding advised or other uncommitted lines of credit;
  - Repurchase or reverse repurchase agreement with the counterparty;
  - Securities lending or securities borrowing transaction with the counterparty;
  - Guarantee, acceptance or letter of credit (including any confirmed letter of credit or standby letter of credit) issued on behalf of the counterparty;
  - Purchase of, or investment in, securities issued by the counterparty;
  - Credit exposure to the counterparty in connection with a derivative transaction between the Covered Company and the counterparty;
  - Credit exposure to the counterparty in connection with a credit derivative or equity derivative transaction between the Covered Company and a third party, the reference asset of which is an obligation or equity security issued by the counterparty; and
  - Any transaction that is the functional equivalent of the above, and any similar transaction that the Board determines to be a credit transaction for purposes of the single-counterparty exposure limits.

[21] This definition of capital stock and surplus is generally consistent with the definition of the same term in the Board's Regulations O and W and the OCC's national bank lending limit regulation. *See* 12 C.F.R. §§ 215.3(i); 223.3(d); *see also* 12 C.F.R. 32.2(b).

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In general, under the Proposed Regulation, the gross credit exposure of a Covered Company to a counterparty for each type of credit transaction described above is as follows:

Type of Credit Transaction	Gross Credit Exposure
Loans (and leases) by a Covered Company to a counterparty	The amount owed by the counterparty to the Covered Company under the transaction
Committed credit lines granted by a Covered Company to a counterparty	The face amount of the credit line
Guarantees and letters of credit issued by a Covered Company on behalf of the counterparty	The lesser of: (1) the face amount; or (2) the maximum potential loss to the Covered Company on the transaction
Debt securities issued by a counterparty and held by the Covered Company	The greater of: (1) the amortized purchase price or market value for trading and available for sale securities; or (2) the amortized purchase price for securities held to maturity[22]
Equity securities issued by a counterparty and held by the Covered Company	The greater of the purchase price or market value
Repurchase agreements	The market value of the securities transferred by the Covered Company to the counterparty, plus an add-on equal to the foregoing multiplied by an applicable collateral haircut applicable to the type of securities involved
Reverse repurchase agreements	The amount of cash transferred by the Covered Company to the counterparty
Securities borrowing transactions	The amount of cash collateral, plus the market value of securities collateral transferred by the Covered Company to the counterparty
Securities lending transactions	The market value of the securities lent by the Covered Company to the counterparty, plus an add-on equal to the foregoing multiplied by an applicable collateral haircut applicable to the type of securities involved
Derivative transactions between the Covered Company and the counterparty *not subject* to a qualifying master netting agreement	The sum of: (1) the current exposure of the derivatives contract equal to the greater of (a) the mark-to-market value of the derivative contract, or (b) zero; and (2) the potential future exposure of the derivatives contract, calculated by multiplying the notional principal amount of the derivative contract by an applicable conversion factor
Derivative transactions between the Covered Company and the counterparty *subject* to a qualifying master netting agreement	The exposure at default amount calculated under 12 C.F.R. part 225, appendix G, § 32(c)(6)[23]

[22] The valuation rules also provide that the amount of the Covered Company's investment in these securities can be no less than the purchase price paid by the Covered Company for the securities, even if the market value of the securities declines below the purchase price.

[23] With respect to cleared and uncleared derivatives, the amount of initial margin and excess variation margin (i.e., variation margin in excess of that needed to secure the mark-to-market value of a derivative) posted to a counterparty should be treated as credit exposure to the counterparty unless the margin is held in a segregated account at a third-party custodian. In the case of cleared derivatives, a Covered Company's contributions to the guaranty fund of a central counterparty would be considered a credit exposure and valued at the notional amount.

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Credit or equity derivative transactions between the Covered Company and a third party, where the Covered Company is the protection provider and the reference asset is an obligation or equity security of the counterparty	The lesser of: (1) the face amount of the transaction; or (2) the maximum potential loss to the Covered Company on the transaction

Pursuant to the Proposed Regulation, gross credit exposure amounts are converted to net credit exposure amounts as follows:

Type of Credit Transaction	Net Credit Exposure
Credit transactions generally, including securities financing transactions and derivatives transactions	The gross credit exposure (or, for securities financing transactions, the net credit exposure), minus: (1) the "adjusted market value"[24] of any "eligible collateral,"[25] provided that: (a) the Covered Company includes such amount in its gross credit exposure to the issuer of the collateral; (b) the same collateral is used to adjust the Covered Company's gross credit exposure to any other counterparty; and (c) the Covered Company's gross credit exposure to the issuer of collateral does not exceed its gross credit exposure to the counterparty on the credit transaction; (2) the amount of any "eligible guarantees"[26] from an "eligible protection provider"[27] that covers the transaction, provided that: (a) the guarantees are included when calculating its gross credit exposure to the protection provider; and (b) the Covered Company's gross credit exposure to the protection provider, with respect to the guarantee, does not exceed its gross credit exposure to the counterparty on the transaction prior to recognition of the guarantee; (3) the notional amount of any "eligible credit or equity derivative"[28] from an eligible protection provider that

[24] Defined, with respect to any "eligible collateral," as the fair market value of the collateral after application of the applicable haircut specified by the Proposed Regulation for that type of collateral.

[25] Generally defined to include: (1) cash on deposit with a Covered Company (including cash held for the Covered Company by a third-party custodian or trustee); (2) debt securities (other than mortgage- or asset-backed securities) that are bank-eligible investments; (3) equity securities that are publicly traded; and (4) convertible bonds that are publicly traded.

[26] Defined as a written guarantee that: (1) is unconditional or contingent only on action by the beneficiary or a third party (for example, servicing requirements); (2) covers all, or a pro rata portion, of the payments of the obligor on the reference entity; (3) gives the beneficiary a direct claim against the protection provider; (4) is not cancelable by the guarantor, other than for breach by the beneficiary; (5) is enforceable in a jurisdiction where the guarantor has sufficient assets; (6) requires the guarantor to make payment in a timely manner without the beneficiary first having to pursue the obligor; and (7) does not increase in cost in response to deterioration of the reference entity's credit quality.

[27] Defined as: (1) a sovereign entity; (2) the BIS, IMF, ECB, EC or a multilateral development bank; (3) a Federal Home Loan Bank or Farmer Mac; (4) a depository institution, BHC, SLHC or FBO; (5) a U.S. registered broker-dealer or licensed insurance company, or a non-U.S. firm subject to comparable consolidated supervision and regulation; or (6) a qualifying central counterparty.

[28] "Eligible credit derivative" means a single-name or standard, nontranched index credit derivative, provided that: (1) it is an "eligible guarantee," confirmed by the parties; (2) any assignment has been confirmed; (3) if a credit default swap, the contract includes the following credit events: (a) failure to pay any amount due under the terms of the reference exposure (subject to any applicable market-standard threshold and a grace period in line with that of the exposure); and (b) bankruptcy, insolvency, inability of the obligor on the reference exposure to pay its debts as they become due, and similar events; (4) the terms governing settlement are incorporated into the contract; (5) if cash settlement is allowed, the contract incorporates a robust valuation process and a reasonable period for valuing the reference exposure; (6) if the purchaser is required to transfer an exposure at settlement, at least one of the eligible exposures is transferable (on no more than reasonable consent); and (7) if a credit default swap, the contract clearly indicates: (a) who determines whether a credit event has occurred; (b) that such determination is not made solely by the protection provider; and (c) gives the purchaser the right to notify the provider of a credit event.

"Eligible equity derivative" means an equity-linked total return swap, provided that: (1) the derivative contract has been confirmed by the parties; (2) any assignment has been confirmed; and (3) the terms governing settlement are incorporated into the contract.

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	references the counterparty, as applicable, provided that: (a) the face amount of the derivative is included when calculating its gross credit exposure to the protection provider; and (b) the Covered Company's gross credit exposure to the protection provider, with respect to the derivative, does not exceed its gross credit exposure to the counterparty on the credit transaction prior to recognition of the derivative; and (4) the face amount of a short sale of the counterparty's debt or equity security
Repurchase and reverse repurchase transactions subject to a bilateral netting agreement	The net credit exposure associated with the netting agreement
Securities lending and borrowing transactions subject to a bilateral netting agreement	The net credit exposure associated with the netting agreement
Credit lines and facilities with unused portions	The gross credit exposure, minus the unused portion to the extent that the Covered Company does not have any legal obligation to advance additional funds, until the counterparty provides the amount of adjusted market value of collateral required with respect to the entire used portion of the extension of credit. To qualify for this reduction, the credit contract must specify that any used portion of the credit extension must be fully secured by collateral that is: (1) cash; (2) U.S. government or agency obligations; or (3) obligations of Fannie Mae, Freddie Mac or any additional U.S. government sponsored entity determined by the Board

V. Risk Management and Risk Committee Requirements

The Proposed Regulation requires a Covered Company, as well as *all* publicly-traded BHC with over $10 billion in total consolidated assets (on an average basis over the prior four quarters), to establish a risk committee of its board of directors to document and oversee, on an enterprise-wide basis, the risk management practices of the company's worldwide operations.[29]

Structure of Risk Committee
The risk committee of a Covered Company or smaller BHC referenced above must:

- Have written charter approved by the board of directors;
- Be chaired by an "independent director," defined as:
  - (For companies publicly traded in the United States) a board member who: (1) is not (and, during the past three years, was not) an officer or employee; (2) is not immediately related to any person who is (or, during the past three years, was) an executive officer; and (3) is an independent director under Item 407 of SEC Regulation S-K, for companies that are publicly traded in the U.S.; or
  - (For companies not publicly traded in the United States) a board member who satisfies the first two criteria above and is demonstrated, to the satisfaction of the Board, to be someone who would qualify as an independent director under the listing standards of a securities exchange, if the company were traded on such an exchange;
- Have at least one member with risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors; and

[29] This requirement is broader than that of Section 165(h) of the Dodd-Frank Act, which does not require private non-bank Covered Companies to establish a risk committee.

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- Meet with appropriate frequency and maintain full records of such proceedings.

The risk committees of a Covered Company must also:

- Not be housed within another committee or be part of a joint committee; and
- Report directly to the Covered Company's board of directors; and
- Receive and review regular reports from a chief risk officer ("CRO")(as discussed below).

Risk Management Framework
The framework overseen by the risk committee must include, on an enterprise-wide basis:

- Risk limitations appropriate to each business line;
- Appropriate policies and procedures relating to risk management governance and practices, and risk control infrastructure;
- Processes and systems for identifying and reporting risks, including emerging risks;
- Monitoring compliance with the company's risk limit structure and policies and procedures relating to risk management governance, practices and controls;
- Effective and timely implementation of corrective actions;
- Specification of management's authority and independence to carry out risk management responsibilities; and
- Integration of risk management and control objectives in management goals and the company's compensation structure.

Larger and more complex companies should have more robust risk management practices and frameworks than smaller, less complex companies. Accordingly, as a company grows or increases in complexity, the company's risk committee should ensure that its risk management practices and framework adapt to changes in the company's operations and the inherent level of risk posed by the company to the U.S. financial system.

Appointment of Chief Risk Officer
As noted above, each Covered Company must also appoint a CRO to implement and maintain appropriate enterprise-wide risk management practices for the company. The CRO must report directly to both the risk committee and the CEO. The CRO must:

- Have risk management expertise commensurate with the company's capital structure, risk profile, complexity, activities, size and other appropriate risk-related factors; and
- Receive compensation appropriately structured to provide for objective risk assessment.

The CRO must directly oversee the following responsibilities on an enterprise-wide bases:

- Allocating delegated risk limits and monitoring compliance with such limits;
- Establishing policies and procedures relating to risk management governance, practices and controls;
- Developing appropriate processes for identifying and reporting risks;
- Managing risk exposures and risk controls;
- Monitoring and testing risk controls;
- Reporting risk management issues and emerging risks; and
- Ensuring that risk management issues are effectively resolved in a timely manner.

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VI. Stress Test Requirements

Pursuant to Section 165(i) of the Dodd-Frank Act, the Proposed Regulation sets forth:

- A framework by which the Board will conduct annual stress tests on Covered Companies ("Supervisory Stress Tests");
- A requirement that each Covered Company conduct its own stress tests ("Company-Run Stress Tests"), on a semi-annual basis; and
- A requirement that *all* BHCs, SLHCs or state member banks with total consolidated assets of more than $10 billion (on an average basis over the prior four quarters) conduct a Company-Run Stress Test on an annual basis.

A summary of the results of each of the foregoing stress tests will be published, as discussed in more detail below.

Annual Supervisory Stress Tests
The Supervisory Stress Tests required under the Proposed Regulation build upon the Board's earlier stress-testing efforts, including its Comprehensive Capital Analysis and Review ("CCAR") and the Supervisory Capital Assessment Program. The new framework would assess the impact of at least three different economic and financial market scenarios ("baseline," "adverse" and "severely adverse")[30] on the consolidated capital of each Covered Company over a forward-looking planning horizon (of at least nine quarters), taking into account all relevant exposures and activities of that company.

In general, the "baseline" scenario would consider the most recently available views of the macroeconomic outlook expressed by public- and private-sector forecasters. The "adverse" scenario could include conditions consistent with a recession of at least moderate intensity. The "severely adverse" scenario would consist of economic and financial conditions that are more unfavorable than those of the adverse scenario and that also include, in some instances, salient factors that are likely to place notable strains on at least some lines of business.[31]

The proposed framework includes an estimate of projected net income and other factors affecting capital in each quarter of the planning horizon, leading to an estimate of how each Covered Company's capital resources would be affected under the scenarios.[32] The primary outputs produced would be pro forma projections of capital positions (including capital levels and regulatory and other capital ratios) for each quarter-end over the planning horizon. It is important to note that the Supervisory Stress Tests would focus on capital adequacy, not all aspects of financial condition.

The Proposed Regulation sets forth a general timeframe for each step of the Supervisory Stress Test cycle as follows:

- By mid-November, the Board would publish the scenarios for the upcoming annual cycle;
- Also by mid-November, Covered Companies would submit regulatory reports and any other required information; [33]
- By mid-February, the Board would complete the Supervisory Stress Tests and compile the results;
- By early March, the Board would give each Covered Company its results; and

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[30] This is in contrast to the Capital Plan Rule, which requires capital plans of BHC Covered Companies to assume four scenarios.

[31] Because the Supervisory Stress Tests would be standardized, they are not expected to fully capture all potential risks that may affect a specific Covered Company's capital.

[32] The Board plans to separately publish an overview of its related stress-testing methodologies, which will include a series of models and estimation techniques to estimate losses and revenues and other factors affecting capital.

[33] The Board plans to issue a separate information collection proposal, detailing the data a Covered Company would be required to submit. The confidentiality of any information submitted will be determined in accordance with the Board's normal rules regarding availability of information. *See generally* 12 C.F.R. Part 261.

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- By early April, the Board would publish a high-level summary of the results for each Covered Company (i.e., company-specific results), including:
  - Estimated losses, including overall losses on loans by subportfolio, available-for-sale and held-to-maturity securities, trading portfolios and counterparty exposures;
  - Estimated pre-provision net revenue;
  - Estimated allowance for loan losses; and
  - Estimated pro forma regulatory and other capital ratios.[34]

Each Covered Company must take the results of the analysis conducted by the Board into account in making changes to:

- Its capital structure (including the level and composition of capital);
- Its exposures, concentrations and risk positions;
- Any plans for recovery;
- Its capital plan (for those companies subject to the Capital Plan Rule); and
- Its resolution plan (aka its "living will") (which is required to be updated within 90 days of the Board publishing the company's Supervisory Stress Test result).

The results of a Supervisory Stress Test may also trigger the application of early remediation requirements, as discussed below.

Company-Run Stress Tests

As indicated above, the Proposed Regulation also requires Covered Companies and BHCs, SLHCs or state member banks with total consolidated assets of more than $10 billion to conduct annual Company-Run Stress Tests (using data as of Sept. 31). Covered Companies are also required to conduct an additional Company-Run Stress Test each year (using data as of March 31).[35]

Under the Proposed Regulation, each annual Company-Run Stress Test must assess the potential impact of three Board-dictated scenarios[36] on the following (over at least a nine-quarter forward-looking planning horizon and taking into account all relevant exposures and activities):

- Potential losses, pre-provision revenues, allowance for loan losses and future pro forma capital positions over the planning horizon, including the impact on capital levels and ratios; and
- Capital levels, including regulatory and any other capital ratios specified by the Board.

The second Company-Run Stress Test required of each Covered Company must use the same methodology as the annual test, but the company is require to create its own set of economic and financial scenarios (using a minimum of three: "baseline," "adverse" and "severely adverse").

All companies subject to the Company-Run Stress Test requirements must establish and maintain a system of controls, oversight and documentation, including policies and procedures, designed to ensure that its stress-testing processes comply with the Proposed Regulation. Such compliance system must be approved

[34] A BHC that becomes a Covered Company no less than 90 days before Sept. 30 of a calendar year must comply with the stress tests requirements, including the timing of required submissions to the Board, from that Sept. 30 forward. A non-bank that becomes a Covered Company no less than 180 days before Sept. 30 must comply from that Sept. 30 forward.

[35] A BHC that becomes a Covered Company no less than 90 days before March 31 or Sept. 30 of a calendar year must comply with the Company-Run Stress Test requirements beginning on March 31 or Sept. 30, as applicable. A non-bank that becomes a Covered Company no less than 180 days before March 31 or Sept. 30 must comply beginning on March 31 or Sept. 30, as applicable. A BHC, state member bank or SHLC whose assets exceed $10 billion (on an average basis over the prior four quarters) no less than 90 days before Sept. 30 of a calendar year must comply beginning on Sept. 30. Notwithstanding any of the foregoing, SLHCs are not subject to the Company-Run Stress Test requirements until they are subject to minimum risk-based capital and leverage requirements.

[36] The Board expects these scenarios to be the same as the ones used to conduct the Supervisory Stress Tests.

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and annually reviewed by the company's board of directors and senior management. At a minimum, the relevant policies must outline the company's stress testing practices and methodologies, validation process, use of stress test results and processes for updating the foregoing. A Covered Company's policies would also need to describe its processes for scenario development.

The Proposed Regulation sets forth a general timeframe for each step of the Company-Run Stress Test cycle as follows:

- By mid-November, the Board would publish the scenarios for the annual tests;
- By Jan. 5, companies would be required to report the results of their annual tests to the Board (along with any related information required by the Board);[37] and
- By July 5, Covered Companies would be required to report the results of their additional tests to the Board (along with any related information required by the Board).

In addition, within 90 days after submitting the results of a Company-Run Stress Test to the Board, the submitting company would be required to publish a summary the results, including:

- A description of the types of risks included;
- A general description of the methodologies employed to estimate losses, revenues, allowance for loan losses and changes in capital positions over the planning horizon;
- The aggregate losses, pre-provision net revenue, allowance for loan losses, net income and pro forma capital levels and capital ratios (including regulatory and any other capital ratios specified by the Board) over the planning horizon under each scenario; and
- For each Covered Company, a high-level description of scenarios developed by the company for its additional stress test, including the key variables used.

Under the Proposed Regulation, the Board would conduct an analysis of the results of each Company-Run Stress Test (as well as the quality of the processes employed). A company would be required to take the results of its Company-Run Stress Tests, in conjunction with the Board's analyses of those results, into account, as appropriate:

- When making changes to its capital structure, exposures, concentrations and risk positions;
- When updating any plans for recovery and resolution; and
- To improve the overall risk management of the company.

Additionally, each Covered Company would be required to consider the results of its Company-Run Stress Tests in developing and updating its capital plan.

VII. Debt-to-Equity Limit for Certain Covered Companies

The Proposed Regulation would also implement Section 165(j) of the Dodd-Frank Act, which requires a Covered Company to maintain a debt-to-equity ratio of no more than 15-to-1,[38] if the Council determines that:

- Such company poses a grave threat to U.S. financial stability, and
- Such a debt limit is necessary to mitigate that risk.

[37] The Board plans to publish for comment a description of items to be included in the required report to the Board. In the case of Covered Companies, such report would be submitted in conjunction with its capital plan submitted under the Capital Plan Rule.

[38] The terms "debt" and "equity" have the same meaning as "total liabilities" and "total equity capital" respectively, as calculated in an Identified Company's reports of financial condition. The 15-to-1 debt-to-equity would be calculated as the ratio of total liabilities to total equity capital minus goodwill.

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In making its determination, the Council must take into consideration the criteria in Sections 113(a) and (b) Dodd-Frank Act, which include, among other things:

- The extent of the leverage of the company;
- Its nature, scope, size, scale, concentration, interconnectedness and activities; and
- Its importance as a source of credit for U. S. households, businesses and state and local governments and as a source of liquidity for the U.S. financial system.

A Covered Company so designated (each, an "Identified Company") would receive written notice from the Board and would have 180 calendar days from the date of receipt to comply with the 15-to-1 debt-to-equity ratio requirement.

The Proposed Regulation would allow an Identified Company to request an extension of up to two additional 90-day periods to comply with this debt-to-equity ratio requirement. Such requests must be made in writing, not less than 30 days prior to the expiration of the existing time period for compliance, and must demonstrate that the Identified Company has made good faith efforts to comply and that each extension would be in the public interest.

The Council may lift the debt-to-equity ratio requirement if it determines that the Identified Company no longer poses a grave threat to U.S. financial stability and that the imposition of the requirement is no longer necessary.

VIII. Early Remediation Requirements

Pursuant to Section 166 of the Dodd-Frank Act, the Proposed Regulation establishes a regime to provide for the early remediation of financial distress at a Covered Company to minimize the probability of its insolvency and potential harm to U.S. financial stability. This proposed regime includes four levels of remediation that increase in stringency as the Covered Company's financial condition deteriorates.

Heightened Supervisory Review ("Level 1 Remediation")
Triggered when a Covered Company first shows signs of financial distress or material risk management weaknesses such that further decline of the company is probable.[39] Also triggered when a Covered Company's market-based indicators cross a threshold based on different percentiles of historical distributions.[40] Level 1 remediation requires the Board to produce a report within 30 days and determine whether the institution should be moved to the next level of remediation. The Board may also use other applicable supervisory authority to cause the Covered Company to take appropriate actions.

Initial Remediation ("Level 2 Remediation")
Triggered when a Covered Company:

- Has a total risk-based capital ratio of less than ten percent, a Tier 1 risk-based capital ratio of less than six percent, or a Tier 1 leverage ratio of less than five percent;
- Has severely adverse stress test results that show its Tier 1 common risk-based capital ratio falling below five percent in any quarter of the planning horizon; or
- Demonstrated multiple deficiencies in meeting the new "enhanced liquidity risk management standards" or "risk committee requirements" (as set forth in the Proposed Regulation and discussed above).

[39] Level 1 remediation is also triggered if it is not in compliance with any regulations adopted by the Board relating to capital plans and stress tests. Although there is no fixed capital-related threshold for Level 1 remediation, weaknesses in a Covered Company's capital structure or capital planning processes could lead to Level 1 remediation, even where the Covered Company's capital ratios exceed the minimum levels for Level 2 remediation.

[40] The Board does not propose to use market-based triggers to subject a Covered Company directly to early remediation Levels 2, 3 or 4 at this time, but may review this approach after gaining additional experience with the use of market data in the supervisory process.

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Covered companies under Level 2 remediation are prohibited from:

- Making a quarterly distribution (including share repurchases) in excess of 50 percent of its average net income for the preceding two calendar quarters;
- Permitting its daily average total assets or daily average total risk-weighted assets to increase by more than five percent, as measured on a both a quarterly and yearly basis; or
- Directly or indirectly acquiring a controlling interest in any company without the prior approval of the Board.

The Covered Company would also be subject to a non-public memorandum of understanding with the Board. The Board may also impose additional limitations or conditions on the conduct or activities of the Covered Company or any of its affiliates as the Board deems appropriate, including those deemed necessary to improve safety and soundness of the Covered Company, promote U.S. financial stability or limit the external costs of a potential failure.

Recovery ("Level 3 Remediation")
Triggered when a Covered Company:

- Has a total risk-based capital ratio of less than eight percent, a Tier 1 risk-based capital ratio of less than four percent or a Tier 1 leverage ratio of less than four percent;
- For two complete consecutive quarters, has a total risk-based capital ratio of less than 10 percent, a Tier 1 risk-based capital ratio of less than six percent or a Tier 1 leverage ratio of less than five percent;
- Has severely adverse stress test results that show its Tier 1 common risk-based capital ratio falling below three percent in any quarter of the planning horizon; or
- Is in substantial non-compliance with the new enhanced liquidity risk management standards or risk committee requirements.

Under Level 3 remediation, the Covered Company would be prohibited from:

- Making any capital distributions or increasing the compensation of, or paying any bonus to, its senior executive officers or directors;
- Permitting its average total assets or average total risk-weighted assets to increase on a quarterly basis;
- Directly or indirectly acquiring any interest in any company;
- Establishing or acquiring any office or other place of business; or
- Engaging in any new line of business.

The Covered Company must also enter into a written agreement or other form of formal enforcement action with the Board, requiring it to raise capital and to take other actions to improve capital adequacy. Failure to satisfy the requirements of the written agreement, could result in the Board requiring the company to:

- Divest assets identified as contributing to the company's financial decline or posing substantial risk of furthering the decline;
- Require new elections for its board of directors;
- Dismiss directors or senior executive officers who have held office for more than 180 days;
- Hire senior executive officers approved by the Board; or
- Limit transactions with its affiliates.

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Furthermore, to the extent that management is a primary cause of the Level 3 remediation status, the Board could take additional action to ensure that such management does not increase the risk profile of the company or make its failure more likely.

Recommended Resolution ("Level 4 Remediation")
Triggered if the Covered Company has a total risk-based capital ratio of less than six percent, a Tier 1 risk-based capital ratio of less than three percent or a Tier 1 leverage ratio of less than three percent. Under Level 4 remediation, the Board must consider whether to recommend to the Treasury Department and the Federal Deposit Insurance Company that the company be resolved under the orderly liquidation authority provided for in Title II of the Dodd-Frank Act.

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If you have any questions concerning this *Memorandum*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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