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ADVISORY

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Federal Reserve Proposes Enhanced Prudential Standards for Large Financial Institutions

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On December 20, 2011, the Board of Governors of the Federal Reserve System (Board) issued a proposed rule and request for public comment[1] (Notice) to implement provisions of Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA).[2] Sections 165 and 166 require the Board to impose enhanced prudential standards on certain large bank holding companies (BHCs) and on nonbank financial companies designated for Board oversight by the Financial Stability Oversight Council (FSOC).[3] These statutory provisions and the regulations proposed by the Board will create significant new obligations and, in some instances, restrictions on the largest participants in the US financial system. The Board has asked for feedback on all aspects of the proposed regulations, including in response to 95 specific questions posed in the Notice. Comments are due March 31, 2012.

Purpose

The recent financial crisis revealed significant limitations in the prudential regulation of large and systemically significant financial companies. At the peak of the crisis, it became clear that many institutions' capital levels were insufficient to support their risk profiles, and that even institutions with adequate capital were, in times of extreme stress, vulnerable to crippling liquidity challenges that rendered capital cushions nearly meaningless. Further, it became evident that neither regulators nor the industry itself fully appreciated the extent to which the largest industry participants, as frequent counterparties, were exposed to one another, such that the failure of one institution could have a "domino effect" on others. It was equally apparent that regulators and the industry alike did not comprehend the extent to which institutions had leveraged themselves and taken on significant amounts

1 "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," Board of Governors of the Federal Reserve System, RIN 7100-AD-86, December 20, 2011 (*available at* http://www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm).

2 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3 Section 113 of the DFA authorizes the FSOC to designate a US nonbank financial company for supervision by the Board if the FSOC determines, pursuant to factors set forth in the DFA, that the US nonbank financial company could pose a threat to the financial stability of the United States. To date, no such designation has been made.

of risk through derivative transactions and other "exotic" instruments, which both caused and amplified the losses experienced during the financial downturn. These factors combined to force an unprecedented level of government intervention to prevent the failure of several of the largest US financial institutions, confirming that those institutions were, in fact, "too big to fail."

Sections 165 and 166 of the DFA seek to address a number of these concerns and to reduce the moral hazards associated with a presumption of government support in times of stress. The provisions' goal is to ensure that large and systemically important institutions can survive future instances of severe market dislocation, or that, if not, the impact of their failure on other market participants will be minimized. Particular emphasis is placed on tightening the requirements governing the financial condition, risk management, and contingency planning of the largest and most interconnected institutions in the United States, so as to prepare proactively for the next market crisis. Although BHCs have always been subject to prudential regulation and agency guidance in these areas, these requirements will be new to nonbank entities, and in any event the DFA specifically requires the Board to impose requirements that go beyond what is currently expected of BHCs.

Significantly, the proposed regulations are not intended solely to strengthen the resiliency of large companies. In some cases, the goal is also to prompt certain large institutions to rein in their activities to address the unintended and undesirable consequences of "too big to fail." To that end, the Board expects that the proposed regulations, which increase in stringency according to the systemic risk posed by an entity, will provide an incentive for financial companies to reduce their systemic footprint—and thereby their systemic risk. The Board views this process as a means of "encourag[ing] covered companies to consider the external costs that their failure or distress would impose on the broader financial system, thus helping to offset any implicit subsidy they may have enjoyed as a result of market perceptions of implicit government support."

Scope

The regulations proposed in the Notice address seven primary areas: risk-based capital and leverage, liquidity, single-counterparty credit limits, overall risk-management and risk committees, stress tests, debt-to-equity limits, and early remediation requirements. Each of these areas is discussed below. In most instances, the proposed rules will apply to two categories of institutions (each a "Covered Company"): (i) BHCs with US$50 billion[4] or more in consolidated assets and (ii) nonbank financial companies designated by the FSOC for Board supervision. With respect to the latter category, the Board acknowledges in the Notice that its exiting BHC-focused regulations and guidance will not in every instance translate well to non-BHC entities, and comments are specifically invited regarding what characteristics of nonbank Covered Companies should be considered in determining how to apply each of the seven areas listed above to such entities.

In addition to Covered Companies, BHCs and state member banks with US$10 billion or more in consolidated assets will be subject to the Notice's stress-test requirement, and publicly traded BHCs with US$10 billion or more in consolidated assets will also be subject to the risk-committee requirements proposed in the Notice. Savings and loan holding companies (SLHCs) and foreign banking organizations[5] (FBOs) are, to differing degrees, covered by portions of Sections 165 and 166 and by the rules proposed in the Notice, but, as discussed below, the Board has largely excluded them from the initial scope of the Notice in favor of forthcoming proposed rulemakings that will address SLHCs and FBOs directly.

Timing of Implementation

The Board has sought in the proposed rulemaking to establish initial and ongoing compliance timeframes that

4 Whether a BHC satisfies the US$50 billion requirement will be based on the average of the BHC's total consolidated assets as reported to the Board for the four previous quarters on Federal Reserve Form FR Y-9C (Consolidated Financial Statements for Bank Holding Companies). The US$10 billion threshold applicable to the stress-test requirements discussed herein is calculated in a similar fashion.

5 FBOs include any foreign nonbank financial company supervised by the Board or any foreign-based bank holding company.

allow institutions sufficient time to implement the necessary internal processes. In recognition of the significant time and resources that many institutions will need to dedicate to achieving compliance with the proposed regulations, the Board has proposed an implementation period of approximately one year from the effective date of the final regulations, or from the date an entity becomes subject to the final rules. The Board has also proposed an ongoing reporting/compliance schedule that seeks to coordinate both new and existing requirements. "For example," the Notice states, "the requirement that Covered Companies conduct stress tests is specifically timed to coordinate with the reporting requirements associated with the capital plan, and the capital plan and stress test requirements are specifically timed to minimize overlap with resolution plan update requirements." The Board has specifically requested feedback on the proposed implementation and compliance schedule.

Savings and Loan Holding Companies and Foreign Banking Organizations

As noted above, both SLHCs and FBOs are subject to certain of the DFA provisions implemented by the proposed regulations. Other provisions will be applied at the Board's discretion. To that end, the proposed regulations themselves, as a technical matter, cover both types of entities. However, the Notice delays the effective date of a majority of the rules proposed in the Notice with respect to SLHCs and FBOs until further rulemakings can be issued.

SLHCs: The DFA requires that all financial companies with US$10 billion or more in total consolidated assets whose primary federal regulator is the Board, which includes SLHCs, conduct an annual stress test. Moreover, although not specifically required by the DFA, the Notice states that the Board will apply the DFA's enhanced prudential standards and early remediation requirements to SLHCs with "substantial banking activities," meaning any SLHC that has US$50 billion or more of total consolidated assets and either (i) has savings association subsidiaries that comprise a quarter or more of the SLHC's total consolidated assets or (ii) controls one or more savings associations with US$50 billion or more in total consolidated assets. The Board will also retain the ability to apply the enhanced standards to any other SLHC as determined on a case-by-case basis on safety and soundness grounds. However, because the proposed rule presupposes that an entity is already subject to consolidated capital requirements, which are still in development for SLHCs, application of the Notice's proposed regulations will be delayed until at least such time as the Board finalizes its capital requirements for such entities.

FBOs: Sections 165 and 166 apply to FBOs that have US banking operations[6] and global consolidated total assets of US$50 billion or more. In crafting regulations to address FBOs, Section 165(b)(2) of the DFA instructs the Board to "give due regard to the principle of national treatment and equality of competitive opportunity" and to "take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States." In recognition of the limitations of existing international agreements on bank regulation and the complex structures and operations of many FBOs, the Board states that crafting suitable rules to apply Sections 165 and 166 to FBOs will be "difficult" and therefore largely exempts FBOs from coverage under the proposed rules in favor of specially tailored rules that are in development. We anticipate that such forthcoming rules for FBOs will attempt to create a regulatory structure as identical as possible to the one proposed in the current Notice, so as to apply similar standards to foreign- and domestic-based organizations alike. In the meantime, foreign-owned domestic BHCs with total consolidated assets of US$50 billion or more will be subject to the proposed rules as would any other similarly situated BHC.

Specific Requirements

1. Risk-Based Capital Requirements and Leverage Limits

To address deficiencies identified in capital levels in stressed environments, and more generally to ensure a

6 US banking operations for these purposes include a US branch, a US agency, or a US subsidiary BHC or bank.

forward-thinking approach to capital management efforts at large institutions, the proposed rule would extend the application of the Board's recently adopted Capital Plan Rule to all Covered Companies, including nonbank financial companies designated by the FSOC.[7] That rule, currently applicable only to BHCs, will require all Covered Companies to meet several risk-based and leverage capital requirements. The compliance date for the proposed capital planning and minimum capital requirements will generally be the later of the effective date of the proposed rule or 180 days after Board designation as a Covered Company.

All Covered Companies will be required to submit annual capital plans to the Board demonstrating in detail the company's ability to maintain capital above the Board's minimum risk-based capital ratios (total capital ratio of eight percent and tier 1 capital ratio of four percent) and tier 1 leverage ratio (four percent) under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon. In addition, Covered Companies will be required to demonstrate an ability to maintain a minimum tier 1 common risk-based capital ratio of five percent over the same planning horizon and under the same conditions. A Covered Company unable to satisfy these requirements generally will be prohibited from making any capital distributions until it provides a satisfactory capital plan to the Board. Covered companies may seek reconsideration or hearing of Board objection by written request.

In certain circumstances the proposed rule will require Covered Companies to obtain prior approval from the Board before making a capital distribution. The Board could require prior approval even where it has previously provided nonobjection to the company's capital plan if, among other things, the company's capital levels fall below Board requirements or the distribution would result in a material adverse change to the organization's capital, liquidity, or earnings structure.

Additionally, the proposed rule will subject nonbank Covered Companies to the same minimum risk-based capital and leverage requirements as BHCs and require them to report risk-based capital and leverage ratios to the Board. Nonbank Covered Companies will be required to hold capital sufficient to meet (i) a tier 1 risk-based capital ratio of four percent and a total risk-based capital ratio of 8 percent, as calculated according to the Board's risk-based capital rules,[8] and (ii) a tier 1 leverage ratio of 4 percent as calculated under the Board's leverage rule.[9] A Covered Company that fails to meet these requirements will be required to notify the Board immediately.

Finally, under the proposed rule's "reservation of authority," the Board could in its discretion require any Covered Company to hold additional capital or subject any Covered Company to other requirements or restrictions if it decided the proposed rule did not adequately mitigate the risks posed by the company to US financial stability.

The proposed rule also contemplates, but does not yet propose, a risk-based capital surcharge, ranging from 100 to 350 basis points based on an entity's systemic footprint, to be levied on a subset of Covered Companies known as Global Systemically Important Banks (G-SIBs). The proposed rule contemplates phasing in the capital surcharge from 2016 to 2019 and requests feedback on how best to craft and implement the surcharge.

2. Liquidity Requirements

Currently, the Board oversees liquidity risk management at BHCs primarily through supervisory guidance rather than regulatory requirements. This approach, while serving well under normal market conditions, proved insufficient in stressed scenarios where traditional sources of liquidity became unavailable amid a broader market paralysis. The proposed rule addresses this shortcoming by requiring all Covered Companies to take a number of prudential steps to manage liquidity risk, with the goal of forcing institutions to develop a better understanding of their liquidity needs under a variety of economic conditions, to identify and shore up areas that present unacceptable liquidity exposure, to

7 12 C.F.R. § 225.8. *See* 76 Fed. Reg. 74631 (December 1, 2011).

8 *See* 12 C.F.R. part 225, Appendix A and G.

9 *See* 12 C.F.R. part 225, Appedix D, section II.

monitor liquidity on an ongoing basis, and to prepare in advance for potential liquidity needs. The requirements increase in stringency based on the systemic footprint of the Covered Company. The specific steps required of Covered Companies include:

- Developing comprehensive and dynamic cash flow projections arising from contractual maturities, new business, funding renewals, customer options, and other potential events that may impact liquidity;
- Conducting monthly and *ad hoc* stress testing of the company's activities, exposures, and risks, including off-balance sheet exposures, based on the various process and system requirements imposed by the proposed rule;
- Maintaining a liquidity buffer of highly liquid, unencumbered assets that is sufficient to meet projected net cash outflows and the projected loss or impairment of existing funding sources for 30 days over a range of liquidity stress scenarios;
- Establishing and updating at least annually a detailed Contingency Funding Plan describing the policies, procedures, and action plans for managing liquidity stress events;
- Establishing and maintaining limits on potential sources of liquidity risk, including limits on (i) concentrations of funding in particular instruments, counterparties, counterparty types, or other liquidity risk identifiers; (ii) the amount of specified liabilities that mature within various time horizons; and (iii) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events;
- Monitoring liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions; and
- Comprehensively documenting all material aspects of the company's liquidity risk-management processes and compliance with the proposed rule and providing such documentation to the Board upon request.

The proposed rule will place much of the responsibility for compliance with these and additional liquidity requirements with the company's board of directors, risk committee, and senior management. The board of directors will be required to establish the Covered Company's overall liquidity risk tolerance (defined as the acceptable level of liquidity risk the Covered Company may assume in connection with its operating strategies) at least annually and to review compliance with that level at least semi-annually. The board of directors will also be required to approve the company's Contingency Funding Plan at least annually.

Ongoing liquidity risk-management obligations will be substantial. A company's risk committee will be required to review and approve the liquidity costs, benefits, and risk of each significant new business line and product prior to implementation, as well as the liquidity stress testing, liquidity buffer, and limits on liquidity risk outlined above. The risk committee will also be required to review the comprehensive cash flow projections, liquidity risk-management information used to assess liquidity risk, and an independent validation of the liquidity stress tests. The company's senior management will be responsible under the proposed rule for implementing the liquidity risk strategies, policies, and procedures and for reporting regularly to the risk committee on the company's liquidity risk profile. Finally, the proposed rule requires an independent review of the company's liquidity risk-management activities to be performed at least annually.

The proposed rule also contemplates, but does not propose, specific quantitative liquidity requirements consistent with the international standards of Basel III. These requirements are to be implemented by Basel Committee member countries in 2015 and 2018.

It is clear that these new rules will require Covered Companies to dedicate significant resources to liquidity planning, monitoring, and maintenance. The enhanced liquidity rules will almost certainly require greater liquidity reserves than currently exist at Covered Companies. As the kinds of highly liquid collateral necessary to offset risky activities typically yield relatively small returns, this result may lead to a migration of certain higher-risk activities to smaller or non-US firms that are not subject to these enhanced rules.

The Board has asked for comments on all aspects of its proposal for enhanced liquidity standards, including whether other possible approaches, such as limits on short-term debt, should be considered as alternative or additional methods for safeguarding liquidity positions at Covered Companies.

3. Single-Counterparty Exposure Limits

Much of the government's justification for its large-scale intervention in financial markets was the avoidance of a potential domino effect that could have followed the failure of the largest financial institutions. To limit the mutual interconnectedness of large institutions, Section 165(e) of the DFA requires the Board to impose concentration limits on Covered Companies. The Board must limit a Covered Company's credit exposure to any unaffiliated company to 25 percent of the Covered Company's capital stock or surplus, or a lower percentage that the Board deems necessary. The regulation must become effective no earlier than July 2013 and no later than July 2015. The Board indicated in the Notice that periodic credit exposure reporting requirements, also required by the DFA, will be developed in coordination with these single-counterparty exposure limits.

Credit Exposure Limits

The proposed rule would limit the aggregate net credit exposure[10] of a Covered Company to any unaffiliated counterparty to 25 percent of the capital stock and surplus of the Covered Company. The aggregate net credit exposure of a Covered Company to any counterparty is calculated on a consolidated basis with respect to both parties, although the Board has invited comments on whether such consolidation is appropriate. Furthermore, the proposed rule would limit the aggregate net credit exposure of a "major covered company" (defined as a BHC with US$500 billion or more in total consolidated assets or a FSOC-designated nonbank company) to any unaffiliated "major counterparty" (defined as a "major covered company" or an FBO that is or is treated as a BHC and has total consolidated assets of US$500 billion or more) to 10 percent of the capital stock and surplus of the "major covered company." The proposed exposure limits will be in addition to the loan-to-one-borrower and investment limits imposed on depository institutions, and the Board has asked what conflicts may arise out the interaction of these various requirements.

Credit Exposure Calculation

Net credit exposure is defined as gross credit exposure adjusted for certain netting agreements or eligible collateral, guarantees, or derivatives. Under the proposed rule, a Covered Company would have gross credit exposure to a counterparty if it engages in any of the following types of credit transactions, with the amount determined according to specific provisions—including in some cases specific multiplier tables—in the proposed rule:

- Loans and leases
- Debt and equity securities
- Repurchase and reverse repurchase agreements
- Securities borrowing or lending transactions
- Committed credit lines
- Guarantees and letters of credit
- Derivative transactions between the Covered Company and the counterparty
- Credit or equity derivative transactions where the Covered Company is the protection provider

The proposed rule includes detailed procedures for calculating the value of the above transactions. The Board has asked for comments on possible impediments to its proposal for calculating gross credit exposure and whether additional or alternative valuation methodologies should be considered.

For purposes of calculating gross credit exposure to a counterparty, the proposed rule restates the "attribution rule" in Section 165(e) of the DFA, which provides that if the proceeds of a credit transaction between a Covered Company and any person are used for the benefit of, or

10 The Board has asked whether, in certain circumstances, limits on gross credit exposure may also be appropriate.

transferred to, a company, the Covered Company must treat the credit transaction as one with that company. The Board recognizes that the attribution rule, if interpreted too broadly, "would lead to inappropriate results and would create a daunting tracking exercise for Covered Companies." It therefore sought to "minimize the scope of application of this attribution rule," and the proposed rule seeks feedback on its efforts to do so.

To arrive at the amount of net credit exposure, gross credit exposure may be adjusted using the following considerations:

- Bilateral netting agreements, with respect to repurchase and reverse repurchase transactions and securities lending and borrowing transactions;
- Market value of any eligible collateral for a credit transaction, as such value is adjusted as set forth in the proposed rule;
- The unused portion of a credit extension, under certain enumerated circumstances;
- Any "eligible guarantee" from an "eligible protection provider," as such terms are defined in the proposed rule, that covers the credit transaction;
- The notional amount of any "eligible credit or equity derivative" from an "eligible protection provider" that references the counterparty, as such terms are defined in the proposed rule; and
- The face amount of a short sale of the counterparty's debt or equity security (i.e., sale of a security that the Covered Company does not own).

When a credit transaction between a covered company and a counterparty is covered by an eligible guarantee or an eligible credit or equity derivative, the above adjustments to the gross credit exposure would be mandatory, and the covered company would substitute credit exposure to the guarantor or the protection provider for credit exposure to the counterparty for purposes of the proposed rule.

The proposed rule would exempt certain categories of credit transactions from the limits on credit exposure, including intraday credit exposure to a counterparty and claims involving the United States and its agencies and certain government sponsored entities. Notably, transactions with US state and local governments and with foreign sovereigns are *not* exempt, and such parties and are treated as counterparties for purposes of the proposed rule—a decision regarding which the Board has invited feedback.

Compliance

A Covered Company must comply with the limits on credit exposure on a daily basis, as of the end of each business day, and must submit a monthly report to the Board demonstrating such compliance. Accordingly, a Covered Company must value many types of credit exposure and related collateral on a continuous basis. There are limited exemptions from this daily compliance requirement where the amount of a Covered Company's capital stock and surplus decreases (which results in a decrease in the credit exposure limit), or where there is a business combination involving either a Covered Company or its counterparties, although compliance must be re-established promptly—typically within 90 days.

We anticipate that the effort needed to achieve compliance with the exposure limits as drafted will be substantial, particularly for very large institutions. As an initial matter, each Covered Company will need to make a qualitative and quantitative assessment throughout the organization of all forms of credit exposure (both direct and "attributed"), all offsets to credit exposure, and all counterparties. Once that process is complete, a Covered Company must determine which counterparties are affiliated with one another, and therefore must be consolidated, for calculation of single-counterparty exposure—a massive undertaking in the case of large multinational enterprises. Finally, these same factors must be monitored throughout the organization on an ongoing, real-time basis in order to satisfy the daily compliance requirement under the proposed rule. In view of the size of some organizations and the sheer volume of transactions that will require tracking and aggregating, implementation of this mandate, if left in its current form, will be daunting.

4. Risk Officer and Risk Committee

A significant component of the government's effort to head off future crises is to require better risk management at large financial institutions. While all banking institutions are already required to have risk-management practices in place, the DFA goes a step further by requiring the establishment of a formal risk committee at large financial institutions. Such requirements, in most instances, would also be new to nonbank financial companies that may become subject to the DFA requirements.

As mandated by Section 165, the Board is proposing that publicly traded nonbank Covered Companies and publicly traded BHCs with US$10 billion or more in total consolidated assets establish a risk committee of the board of directors to document and oversee enterprise-wide risk-management policies and practices. The proposed rule will require certain procedures for risk committees, including a formal, written charter that is approved by the company's board of directors, regular meetings, full documentation and maintenance of records of proceedings, and direct reporting to the company's board of directors. The risk committee's substantive duties would include reviewing and approving an institution-appropriate risk-management framework that includes the company's stated risk limitations for each business line, processes for identifying and reporting risks and deficiencies, and specification of management's authority to carry out risk-management duties. The proposed rule would also require Covered Companies to appoint a chief risk officer who will implement and maintain the risk-management framework and practices approved by the risk committee.

The proposed standards would be more stringent for risk committees of Covered Companies than for other entities subject to the risk committee requirement. The Board expects the expertise of the risk-committee membership to be commensurate with the complexity and risk profile of the organizations. Thus, the requirements of the proposed rule would increase in stringency with the systemic footprint of the company. Additionally, all banking organizations supervised by the Board must continue to follow existing Board guidance on risk management.

The Board has requested feedback on whether it should establish independence and competence requirements for service as a member of the risk committee or as the chief risk officer, or whether the proposed rules are sufficient. The Board has also asked for comments on the appropriate role of members of the risk committee in overseeing enterprise-wide risk management, the scope of that role, and how to ensure that the committees are sufficiently supported to carry out their duties. As the parameters of potential director liability will flow from these requirements, institutions that are potentially subject to the proposed rule will want to consider these questions carefully and respond as appropriate.

5. Stress Tests

The proposed rules implement Section 165's requirement that the Board conduct annual stress tests of Covered Companies under baseline, adverse, and severely adverse scenarios, and publicly disclose information on the company-specific results of those tests. The supervisory tests would evaluate whether each Covered Company has the necessary capital to absorb losses under the "normal" and adverse economic and financial conditions of the designated scenarios. This evaluation would include a review, among other things, of the Covered Company's estimated losses, pre-provision net revenue, allowance for loan losses, and the impact of those factors on the company's capital position. The Board would update the scenarios each year to reflect changes in the outlook for economic and financial conditions.

The Board intends to conduct the supervisory stress tests using data supplied by each Covered Company. The tests would use information regarding the company's on- and off-balance sheet exposures to evaluate the sensitivity of the company's revenues and expenses to several economic and financial scenarios. The Board will issue a separate proposal outlining the specific data requirements. The Board will also publish a separate overview of its methodology for the supervisory stress tests.

Additionally, the proposed rules implement Section 165's requirement that any financial company regulated by a primary federal financial regulatory agency that has more than US$10 billion in total consolidated assets conduct its own annual stress test, and that Covered Companies conduct additional semi-annual stress tests. For the semi-annual company-run test, a Covered Company would be required to create and employ its own scenarios reflecting a minimum of three sets of economic and financial conditions—baseline, adverse, and severely adverse conditions—and any additional conditions that the Board requires. The company must then report to the Board the results of the stress tests, publish a summary of the results,[11] and take the results of the stress tests and the Board's analyses thereof into account in making appropriate changes to the company's capital structure, concentrations, and risk positions. The Board may also require other actions consistent with safety and soundness of the company.

While Sections 165 and 166 generally do not apply to SLHCs, the company-run stress test requirement does apply to SLHCs with US$10 billion or more in total consolidated assets (as well as to state member banks with total assets of US$10 billion or more). However, as with other provisions of the proposed rulemaking, the effective date of this requirement for SLHCs will be delayed until the Board has established risk-based capital requirements for SLHCs.

6. Debt-to-Equity Limit

Section 165(j) of the DFA requires the Board to limit a Covered Company's debt-to-equity ratio (calculated as the ratio of a company's total liabilities to its total equity capital less goodwill) to 15 to 1, upon a determination by the FSOC that the company poses a grave threat to the financial stability of the United States and that the limit is necessary to mitigate the risk posed by the company to the financial stability of the United States. It also requires the Board to establish procedures and timelines for complying with the limit. The proposed rule would require a Covered Company to comply with the limit within 180 days of receiving written notice from the FSOC of its determination under Section 165(j) of the DFA. It would allow the Board to extend the time for compliance for up to two additional periods of 90 days each. The limit would cease to apply upon notice from the FSOC that the company no longer poses a grave threat to the financial stability of the United States and that the imposition of the limit is no longer necessary.

7. Early Remediation

While Congress and the Board obviously hope that the enhanced prudential standards created by the DFA and the proposed rules will prevent further crises, a framework is nonetheless established in the proposed rule, consistent with Section 166 of the DFA, for the Board to take specific steps to address weaknesses and, if necessary, failures of Covered Companies. The process established in the proposed rules is intended to go beyond the Prompt Corrective Action mechanism used by the federal banking agencies, which mandates progressively stronger remedial action as the condition of an insured depository institution deteriorates and which was criticized as insufficient to protect the deposit insurance fund in recent years. In addition to Covered Companies, the Board also would impose early remediation requirements on SLHCs with substantial banking activities once the Board has established risk-based capital requirements for them.

Under the proposed rule, the Board would impose certain remediation requirements on Covered Companies based on various triggering events, including the Board's existing definitions of minimum risk-based capital and leverage ratios, the results of the Board's supervisory stress tests under the proposed rule, market indicators, and weaknesses in complying with enhanced risk-management and liquidity standards under the proposed rule. The Board would like to be advised of any possible alternative or additional triggering events that may be employed in the proposed rulemaking. The Board is also particularly interested in comments regarding the market indicators it has proposed as triggering events for remedial actions.

11 The Board has asked for feedback on the benefits and drawbacks of company-specific disclosures and whether any alternatives should be considered.

The proposed rule establishes four levels of remediation requirements that are designed to identify emerging issues before they develop into larger problems. At the first level—heightened supervisory review—the Board would conduct a targeted review of the Covered Company to determine if it is experiencing financial distress or material risk-management weaknesses such that it should be moved to the next level of remediation. At the second level—initial remediation—a Covered Company would be subject to restrictions on growth and capital distributions. At the third level—recovery—a firm would face growth and capital-distribution prohibitions, executive compensation limitations, and capital raising requirements. Finally, at the fourth level—recommended resolution—the Board would determine whether to recommend that the firm be resolved under the orderly liquidation authority created by the DFA. Required actions would vary based on the severity of the situation.

The proposed early remediation regime would be in addition to the Board's other supervisory processes with respect to Covered Companies and would in no way diminish the Board's authority to initiate administrative actions, under Section 8 of the Federal Deposit Insurance Act and elsewhere, to address supervisory concerns.

Conclusion

The proposed regulations are a significant step towards implementing the enhanced prudential standards mandated by the DFA. While the rules attempt to create a more resilient and potentially less-interdependent industry, the implementation of the rules will not be without cost. In recognition of the far-reaching impact of this rulemaking, the Board has posed nearly 100 specific questions in the Notice that address multiple aspects of each element of the proposal. Industry participants that may be subject to these proposed rules should give careful consideration to their feasibility and whether better, less onerous alternatives may be available that would achieve the results required under the DFA. Large SLHCs and FBOs, for which similar rulemakings are forthcoming, will certainly wish to review the current proposal in the context of their unique organizational structures to assist the Board in crafting appropriate implementing regulations.

We hope you have found this Advisory useful. If you would like more information or assistance in addressing the issues raised in this Advisory, please feel free to contact:

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