BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	October 24, 2018
To:	Board of Governors
From:	Vice Chairman for Supervision Quarles
Subject:	Notices of proposed rulemaking to tailor prudential standards

Attached are a memorandum to the Board and two draft notices of proposed rulemaking to establish a revised framework for applying prudential standards to large U.S. banking organizations based on risk, consistent with section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act.

The first draft notice is a Board-only proposal that would tailor the application of prudential standards to U.S. bank holding companies and apply enhanced standards to certain large savings and loan holding companies. The second draft notice, which would be issued jointly with the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation (together with the Board, the agencies), is a proposal to tailor the application of the agencies' capital and liquidity rules. The proposals seek to more closely align the regulatory requirements that apply to large banking organizations with their risk profiles. The proposed framework would not apply to the U.S. operations of foreign banking organizations.

I have reviewed the proposals and believe they are ready for the Board's consideration.

Attachments

Date: October 24, 2018

To: Board of Governors

From: Staff[1]

Subject: Notices of proposed rulemaking to tailor prudential standards

ACTIONS REQUESTED: Approval of two attached draft notices of proposed rulemaking that would establish a revised framework for applying prudential standards to large U.S. banking organizations based on their risk profile: (1) a Board-only proposal that would tailor the application of prudential standards to U.S. bank holding companies as well as apply enhanced standards to certain savings and loan holding companies, and (2) a proposal that would be issued jointly with the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) (the OCC and FDIC, together with the Board, the agencies) that would tailor the application of the agencies' capital and liquidity rules to large U.S. banking organizations. Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.

EXECUTIVE SUMMARY:

- Post-financial crisis reforms have resulted in substantial gains in the resiliency of large banking organizations and the financial system as a whole. Notable advances include higher amounts of better quality capital, a robust framework for assessing the capital adequacy of banking organizations under stressful financial and economic conditions, reductions in levels of short-term wholesale funding, higher buffers of liquid assets, and improvements in resolvability.

[1] Michael Gibson, Mary Aiken, Anna Lee Hewko, Molly Mahar, Rick Naylor, Constance Horsley, Christine Graham, Elizabeth MacDonald, Celeste Molleur, Brian Chernoff, J. Kevin Littler, Peter Stoffelen, Sean Healey, Matthew McQueeney, Christopher Powell, Hillel Kipnis, and Amy Lorenc (Division of Supervision and Regulation); and Mark Van Der Weide, Laurie Schaffer, Ben McDonough, Asad Kudiya, Mary Watkins, and Alyssa O'Connor (Legal Division).

- The proposals seek to more closely align, or tailor, the Board's prudential standards for large U.S. banking organizations with the risk profiles of these firms while still maintaining the gains made over the past decade.

- The proposals build on the Board's existing tailoring of its rules and experience implementing those rules, and account for changes to the enhanced prudential standards requirements made by the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA).

- The proposals would establish a revised framework for applying prudential standards to large U.S. banking organizations, with four categories of standards that reflect the different risks of firms in each group:

    - Category IV: Most firms with $100 billion to $250 billion in total assets would be subject to significantly reduced requirements. In particular, these firms would no longer be subject to standardized liquidity requirements or a requirement to conduct and publicly disclose the results of company-run capital stress tests.

    - Category III: Firms with $250 billion or more in assets, or firms with at least $100 billion in assets that exceed certain risk thresholds, would be subject to enhanced standards that are tailored to the risk profile of these firms.

    - Category II: Firms of global scale—those with very significant size ($700 billion or more in total assets) or cross-jurisdictional activity ($75 billion or more)—would be subject to more stringent prudential standards (based on global standards developed by the Basel Committee on Banking Supervision (BCBS)) and other prudential standards appropriate to very large or internationally active banking organizations.

    - Category I: U.S. global systemically important bank holding companies (GSIBs) would remain subject to the most stringent standards.

- The adjustments would significantly reduce regulatory compliance requirements for firms subject to Category IV standards, modestly reduce requirements for firms subject to Category III standards, and largely keep existing requirements in place for firms subject to Category I and II standards.

- The proposals consist of two separate Federal Register notices:

    - The Board-only proposal would tailor prudential standards relating to capital stress testing; risk management; liquidity risk management, liquidity stress testing, and liquidity buffer requirements; and single-counterparty credit limits.

    - The Board-only proposal would also apply enhanced prudential standards to certain savings and loan holding companies to further their safety and soundness and increase consistency of the regulatory framework across similarly situated large U.S. banking organizations.

    - The interagency proposal would tailor requirements under the agencies' capital rule, the liquidity coverage ratio (LCR) rule, and the proposed net stable funding ratio (NSFR) rule.

- The proposed changes would not apply to foreign banking organizations, including to an intermediate holding company of a foreign banking organization. Staff intends to present a proposal to the Board in the near future on the applicable prudential standards for foreign banking organizations.

- Staff also intends to present a separate proposal to the Board in the near future that would, jointly with the FDIC, further differentiate resolution planning requirements for large firms.

- The proposals would not modify regulatory capital requirements for firms that would be subject to Category I or II standards. For firms that would be subject to Category III or IV standards, staff expects the proposal to slightly lower capital requirements under current conditions and reduce compliance costs related to capital planning, stress testing, and, for certain firms, the advanced approaches capital requirements. The impact on capital levels for these firms could vary under different economic and market conditions.

- Staff estimates that the proposed reduction in LCR and NSFR requirements would moderately reduce the liquidity buffers held at firms subject to Category III or IV standards. The proposal would continue to require these firms to conduct internal liquidity stress tests and hold highly liquid assets sufficient to meet projected 30-day net stressed cash-flow needs under internal stress scenarios. In addition, the Federal Reserve will continue to assess the safety and soundness of these firms through the normal course of supervision. Since liquidity buffers come at a cost to banks and banks may pass along their costs to their customers, moderately smaller liquidity buffers would modestly reduce these costs. At the same time, smaller liquidity buffers could moderately increase the likelihood that a firm could experience liquidity pressure during times of stress. This tradeoff would reflect the more limited impact the distress or failure of affected firms would have on the financial system as a whole, relative to firms with more significant systemic footprints. The tailoring of liquidity risk management requirements would also reduce compliance burdens at affected firms.

DISCUSSION:

A. Background

To address weaknesses in the banking sector that were evident in the financial crisis, and consistent with section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Dodd-Frank Act),[2] the Board adopted enhanced prudential standards that apply to bank holding companies with $50 billion or more in total assets. These standards, which generally increase in stringency with the size and systemic footprint of a firm, are designed to help prevent or mitigate risks to U.S. financial stability that could arise from the material financial distress, failure, or ongoing activities of these firms, and to improve these firms' safety and soundness. The standards, along with other post-crisis reforms, have resulted in substantial gains in resiliency for individual firms and for the financial system as a whole.

In implementing the Dodd-Frank Act, the Board tailored its regulations to broadly reflect the different risks of large banking organizations. Since that implementation and as part of the Board's normal practice of regularly reviewing whether its rules are functioning as intended, Board staff has been assessing whether further tailoring for large banking organizations is appropriate. The proposals reflect this work, as well as the changes made by EGRRCPA to the Dodd-Frank Act provisions on enhanced prudential standards for large banking organizations.[3] Specifically, EGRRCPA raised the $50 billion minimum asset threshold for general application of enhanced prudential standards to $250 billion, and provides the Board with discretion to apply standards to bank holding companies with total assets of between $100 billion and $250 billion.[4] In determining the standards that apply to firms above or below $250 billion in assets, the Board must take into consideration certain factors, including capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate.

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

[3] Pub. L. No. 115-174, 132 Stat. 1296 (2018).

[4] EGRRCPA also requires enhanced prudential standards to apply to U.S. GSIBs. Id. at § 401(f).

Consistent with this mandate, the proposals build on the Board's existing practice of differentiating capital, liquidity, and other requirements based on the size, complexity, and overall risk profile of banking organizations.

B. Proposed Approach to Tailoring

The proposals would establish categories of prudential standards to better align those requirements with a firm's risk profile and to continue to apply consistent standards across similarly situated firms. In particular, the proposals would differentiate firms based on their size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, off-balance sheet exposure, and whether a firm is identified as a U.S. GSIB under the Board's rules. Other than risk committee and related risk management requirements, the proposals would eliminate enhanced regulatory requirements for banking organizations with less than $100 billion in total assets, consistent with their safety and soundness and lesser risk.[5] Both proposals would apply to bank holding companies as well as savings and loan holding companies that are not substantially engaged in insurance underwriting or commercial activities (covered savings and loan holding companies).[6]

Under this approach, four categories of standards would apply:

- Category IV: Most firms with $100 billion to $250 billion in total assets would be subject to significantly reduced requirements that reflect their risks.
- Category III: Firms that have total assets of $250 billion or more, or those with total assets of $100 billion or more that also have $75 billion or more of a risk-

[5] Risk committee and risk management requirements would apply to firms with $50 billion or more in total assets. (See pp. 62-64 of the Board-only proposal.)

[6] The Board-only proposal would also make changes to the Board's implementation of certain definitions in the Dodd-Frank Act in light of amendments made by EGRRCPA. (See pp. 64-65 of the Board-only proposal.)

based indicator (weighted short-term wholesale funding, nonbank assets, or off-balance sheet exposure), would be subject to enhanced standards that are tailored to the risk profile of these firms.

- Category II: Firms of global scale—those with very significant size ($700 billion or more in total assets) or cross-jurisdictional activity ($75 billion or more)—would be subject to more stringent prudential standards (based on global standards developed by the BCBS) and other prudential standards appropriate to very large or internationally active banking organizations.

- Category I: U.S. global systemically important bank holding companies (GSIBs) would remain subject to the most stringent standards.

C. Risk-Based Indicators to Determine the Applicable Category of Standards

To determine the appropriate set of standards for a given firm, the proposals would use thresholds based on size, cross-jurisdictional activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposure. Each of these indicators would reflect both safety and soundness and financial stability risks.

- Size. An asset size threshold would reflect the greater economic impact of the failure or distress of a larger banking organization compared to that of a smaller firm, and the challenges of conducting an orderly resolution of a very large firm that fails.[7] Larger firms also face safety and soundness risks associated with greater managerial and operational complexity. The use of an asset size threshold would be consistent with section 165 of the Dodd-Frank Act, as amended by EGRRCPA.

- Cross-jurisdictional activity. Cross-jurisdictional activity can affect both the complexity and resolvability of a firm. In particular, foreign operations and cross-border positions

[7] *See* Lorenc, Amy G., and Jeffery Y. Zhang (2018). "The Differential Impact of Bank Size on Systemic Risk," *Finance and Economics Discussion Series* 2018-066. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2018.066.

add operational complexity in normal times and complicate the ability of a firm to undergo an orderly resolution in times of stress, generating both safety and soundness and financial stability risks.

- Weighted short-term wholesale funding.[8] Reliance on short-term, uninsured funding from more sophisticated counterparties can make a firm vulnerable to large-scale funding runs. In addition, banking organizations that fund long-term assets with short-term liabilities from financial intermediaries may need to rapidly sell less liquid assets to meet withdrawals and maintain their operations in a time of stress, which they may be able to do only at "fire sale" prices. Such asset fire sales can cause rapid deterioration in a firm's financial condition and negatively affect broader financial stability by driving down asset prices across the market.
- Nonbank assets. The level of a firm's investment in nonbank subsidiaries provides a measure of business and operational complexity. Nonbank activities may also involve a broader range of risks than those associated with purely banking activities, and can increase interconnectedness with other financial firms. In addition, nonbank assets reflect the degree to which a firm may be engaged in activities through legal entities that are not subject to the direct regulation and supervision applicable to a regulated banking entity. Because nonbank subsidiaries will not be resolved through the FDIC's

[8] The proposed weighted short-term wholesale funding indicator would track the measure currently reported on the FR Y-15 and be consistent with the calculation used for purposes of the GSIB surcharge rule. Categories of short-term wholesale funding are weighted based on four residual maturity buckets; the asset class of collateral, if any, backing the funding; and characteristics of the counterparty. *See* 12 CFR 217.406.

receivership process, significant investments in nonbank subsidiaries can present heightened resolvability risk.

- Off-balance sheet exposure. Off-balance sheet exposure reflects risks of a firm that are not included on its balance sheet, including relating to derivatives, securities borrowing and lending, and committed extensions of credit. These exposures can be a source of safety and soundness risk, as firms with significant off-balance sheet exposure may have to fund these positions in the market in a time of stress, which can put a strain on both capital and liquidity. In addition, because draws on off-balance sheet exposures such as committed credit and liquidity facilities tend to increase in times of stress, they can exacerbate the effects of stress on a banking organization and the financial system more broadly.

The proposals would set a threshold of $75 billion for each of these indicators other than size. A threshold of $75 billion would represent a very significant level relative to the size of a firm – for example, between 30 and 75 percent of the assets of a banking organization with $100 billion to $250 billion in total assets. (See pp. 20-40 of the Board-only proposal and pp. 18-31 of the interagency proposal.)

As an alternative to this thresholds-based approach, the proposals request comment on use of the GSIB identification methodology under the Board's GSIB surcharge rule to determine the applicable category of standards for banking organizations with $100 billion or more in total assets.[9] This alternative is described in section III.C of the preamble to the Board-only proposal and section II.B.3 of the preamble to the interagency proposal. The proposals request comment

[9] *See* 12 CFR Part 217, Subpart H.

on ranges for potential cutoffs of scores for Categories II-IV and invite comment on the methodology and conclusions.

The appendix summarizes notable proposed changes in prudential standards for each category, relative to current requirements, and shows the projected set of firms that would be subject to each category of standards under the proposals.[10]

D. Category IV: Banking Organizations with Assets of at Least $100 Billion but Less than $250 Billion that Do Not Meet a Risk Threshold

A banking organization would be subject to Category IV standards if it has total assets of at least $100 billion but less than $250 billion, and does not meet any of the proposed risk thresholds. These standards would include reductions from current requirements to reflect the risks of these firms:

- Capital. The preamble to the Board-only proposal notes that staff intends to present a proposal to the Board to provide these firms with additional flexibility in developing their annual capital plans submitted in connection with the Board's Comprehensive Capital Analysis and Review (CCAR). (See pp. 50-57 of the Board-only proposal.)
- Liquidity. These firms would no longer be subject to the LCR or proposed NSFR rules. (See pp. 46-48 of the interagency proposal). In addition, they would be subject to quarterly (rather than monthly) internal liquidity stress testing and simplified liquidity risk management requirements, including monthly (rather than weekly) collateral monitoring requirements and

[10] In addition to proposed changes to regulations, the Board-only proposal includes changes to related reporting forms and instructions. (See pp. 66-69 of the Board-only proposal.)

tailored risk limit and intraday monitoring requirements. (See pp. 50-57 of the Board-only proposal.)

- Stress testing: These firms would be subject to supervisory stress testing every two years, rather than annually, and would no longer be required to conduct and publicly report the results of a company-run stress test. These firms would be expected to have sound capital planning practices. (See pp. 50-57 of the Board-only proposal.)

E. Category III: Banking Organizations with Assets of $250 Billion or More, or $100 Billion to $250 Billion That Meet a Risk Threshold

Banking organizations with total consolidated assets of $250 billion or more, or that meet a risk threshold, would be subject to Category III standards. Relative to Categories I and II, Category III would include fewer standards that are based on standards published by the BCBS, to reflect the relatively lower risk profiles and lesser degree of cross-border activity of subject firms.

- Capital. These firms would no longer be subject to internal models-based risk-based capital requirements, otherwise known as "advanced approaches" capital requirements. (See pp. 43-45 of the interagency proposal).
- Liquidity. Firms without a significant reliance on short-term wholesale funding would be subject to reduced LCR and proposed NSFR requirements, proposed between 70 and 85 percent of the full LCR and NSFR requirements. Firms with weighted short-term wholesale funding of $75 billion or more would be subject to the full LCR and proposed NSFR requirements. (See pp. 48-52 of the interagency proposal).

- Stress testing: These firms would remain subject to annual supervisory stress testing, but would be required to conduct and publicly report the results of a company-run stress test every two years instead of semi-annually.[11] (See pp. 45-50 of the Board-only proposal.)

F. Category II: Banking Organizations with Very Significant Size or Cross-Jurisdictional Activity

Banking organizations with total consolidated assets of $700 billion or more, or with $75 billion or more in cross-jurisdictional activity, would be subject to Category II standards. Category II standards would include enhanced quantitative capital and liquidity requirements (based on global standards developed by the BCBS) and other prudential standards appropriate to very large or internationally active banking organizations. These proposed standards are generally consistent with the standards that currently apply to these firms; however, consistent with EGRRCPA, these firms would be required to conduct and publicly disclose the results of a company-run stress test on an annual, rather than semi-annual basis. (See pp. 42-45 of the Board-only proposal and pp. 41-43 of the interagency proposal.)

The application of consistent prudential standards across jurisdictions to banking organizations with significant size or international activity helps to promote competitive equity among U.S. banking organizations and their foreign peers and competitors, while applying standards that appropriately reflect the risk profiles of firms in this category. In addition, international consistency of standards can facilitate U.S. banking organizations' regulatory compliance in foreign markets.

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[11] The proposal would continue to require a firm subject to Category III standards to conduct an internal stress test on an annual basis in connection with the firm's CCAR capital plan submission.

G. Category I: U.S. GSIBs

U.S. GSIBs would be subject to Category I standards, which are the most stringent requirements, in light of the financial stability risk posed by these firms. The proposal would make no changes to the requirements applicable to U.S. GSIBs, except to reduce the frequency of required company-run stress testing from semi-annual to annual. (See pp. 40-42 of the Board-only proposal and pp. 40-41 of the interagency proposal.)

H. Covered Savings and Loan Holding Companies

The proposals aim to achieve parity in the prudential regulation of similarly situated bank holding companies and savings and loan holding companies because of the significant similarities in the activities and risk profiles of such institutions.[12] The Board-only proposal would apply risk management, liquidity risk management, capital and liquidity stress testing, liquidity buffer, and single-counterparty credit limits requirements to covered savings and loan holding companies to the same extent as if they were bank holding companies.[13] Such standards would promote safety and soundness by increasing the resiliency and risk management of these savings and loan holding companies. (See pp. 16-19 and 57-62 of the Board-only proposal.) The interagency proposal would continue to apply capital and liquidity standards to covered savings and loan holding companies.

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[12] These requirements would not apply to savings and loan holding companies predominantly engaged in insurance or commercial activities.

[13] The Board proposes to apply these prudential standards to covered savings and loan holding companies using the Board's authority under the Home Owners' Loan Act of 1933, 12 U.S.C. 1467a. For more discussion of the Board's application of prudential standards to covered savings and loan holding companies, see section II.B.2 of the preamble to the Board-only proposal.

RECOMMENDATIONS:

For the reasons discussed above, staff recommends that the Board approve the attached draft notices of proposed rulemaking. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the attached materials prior to publication.

Attachments

Appendix

Proposed Requirements*

	Category I	Category II	Category III	Category IV	Other Firms
	U.S. GSIBs	≥ $700b Total Assets or ≥ $75b in Cross-Jurisdictional Activity	≥ $250b Total Assets or ≥ $75b in NBA, wSTWF, or Off-balance sheet exposure	Other firms with $100b to $250b Total Assets	$50b to $100b Total Assets
Capital	**TLAC/Long-term debt** **Stress Testing** • CCAR qualitative and quantitative • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • GSIB surcharge • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Enhanced supplementary leverage ratio	**Stress Testing** • CCAR qualitative and quantitative • Annual company-run stress testing • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Advanced approaches • Countercyclical Buffer • No opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage Ratio	**Stress Testing** • CCAR qualitative and quantitative • Company-run stress testing every other year • Annual supervisory stress testing • Annual capital plan submission **Risk-Based Capital** • Countercyclical Buffer • Allow opt-out of AOCI capital impact **Leverage capital** • Supplementary leverage ratio	**Stress Testing** • CCAR quantitative (two-year cycle) • Supervisory stress testing (two-year cycle) • Annual capital plan submission **Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**	**Risk-Based Capital** • Allow opt-out of AOCI capital impact **Leverage capital**
Liquidity	**Standardized** • Full LCR (100%) • Full NSFR (100%) **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Standardized** • Full LCR (100%) • Full NSFR (100%) **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Standardized** • Reduced LCR (70-85%)† • Reduced NSFR (70-85%)† **Internal** • Liquidity stress tests (monthly) • Liquidity risk management	**Internal** • Liquidity stress tests (quarterly) • Tailored liquidity risk management	

* This figure does not reflect risk committee and related risk management requirements or single-counterparty credit limits.
† For firms subject to Category III requirements with wSTWF of $75 billion or more, 100% LCR and NSFR requirements would apply. For firms subject to Category III requirements with less than $75 billion in wSTWF, the proposal would request comment on reducing the LCR and NSFR requirements to a level between 70-85%.
Glossary: NBA – nonbank assets; wSTWF – weighted short-term wholesale funding; AOCI – accumulated other comprehensive income; CCAR – Comprehensive Capital Analysis and Review; GSIB – global systemically important bank holding company; LCR – liquidity coverage ratio rule; NSFR – net stable funding ratio proposed rule; TLAC – total loss-absorbing capacity.

Appendix

List of Firms by Projected Category[14]

Category I	Category II	Category III	Category IV	Other firms
U.S. GSIBs	≥ $700b Total Assets or ≥ $75b in Cross-Jurisdictional Activity	≥ $250b Total Assets or ≥ $75b in NBA, wSTWF, or Off-balance sheet exposure	Other firms with $100b to $250b Total Assets	$50b to $100b Total Assets
JPMorgan Chase Bank of America Citigroup Wells Fargo Goldman Sachs Morgan Stanley Bank of New York Mellon State Street	Northern Trust	U.S. Bancorp PNC Financial Capital One Charles Schwab	BB&T Corp. SunTrust Inc. American Express Ally Financial Citizens Financial Fifth Third KeyCorp Regions Financial M&T Bank Huntington Discover	Synchrony Financial Comerica Inc. E*TRADE Financial Silicon Valley Bank NY Community Bancorp

[14] Projected categories are based on data for Q2 2018. Actual categories would be based on 4-quarter averages.