

**Federal Reserve System**

**12 CFR Parts 211 and 238**

**Docket No. R-1569**

**RIN 7100-AE82**

**Large Financial Institution Rating System; Regulations K and LL**

**AGENCY:** Board of Governors of the Federal Reserve System (Board).

**ACTION:** Final Rule.

**SUMMARY:** The Board is adopting a new rating system for large financial institutions in order to align with the Federal Reserve's current supervisory programs and practices for these firms. The final rating system applies to bank holding companies and non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more, and U.S. intermediate holding companies of foreign banking organizations established under Regulation YY with total consolidated assets of \$50 billion or more. The rating system will assign component ratings for capital planning and positions, liquidity risk management and positions, and governance and controls, and introduces a new rating scale. The Federal Reserve will assign initial ratings under the new rating system in 2019 for bank holding companies and U.S. intermediate holding companies subject to the Large Institution Supervision Coordinating Committee framework and in 2020 for all other large financial institutions. The Board is revising provisions in Regulations K and LL so they will remain consistent with certain features of the new rating system.

**DATES:** The final rule is effective on February 1, 2019.

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## **SUPPLEMENTARY INFORMATION:**

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## I. Background

The Board is adopting a new supervisory ratings framework for certain large financial institutions that is designed to:

- Align with the Federal Reserve’s current supervisory programs and practices;
- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

The final ratings framework applies to bank holding companies and non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more, and U.S. intermediate holding companies of foreign banking organizations established under Regulation YY with total consolidated assets of \$50 billion or more.

In the years following the 2007-2009 financial crisis, the Federal Reserve developed a supervisory program specifically designed to enhance resiliency and address the risks posed by large financial institutions to U.S. financial stability (LFI supervisory program). As set forth in SR letter 12-17/CA letter 12-14, the LFI supervisory program focuses supervisory attention on the core areas that are most likely to threaten the firm’s financial and operational strength and resilience (capital, liquidity, and governance and controls).<sup>1</sup> This orientation is intended to reduce the likelihood of the failure or material distress of a large financial institution, and reduce the risk to U.S. financial stability in the event of failure.

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<sup>1</sup> “Financial strength and resilience” is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

“Operational strength and resilience” is defined as maintaining effective governance and controls to provide for continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

Under SR letter 12-17/CA letter 12-14, “banking offices” are defined as U.S. depository institution subsidiaries and the U.S. branches and agencies of foreign banking organizations.

The Federal Reserve coordinates its supervision of firms that pose the greatest risk to U.S. financial stability through the Large Institution Supervision Coordinating Committee (LISCC). The LISCC supervisory program conducts annual horizontal reviews of LISCC firms and firm-specific examination work focused on evaluating those firms' (i) capital adequacy under normal and stressed conditions; (ii) liquidity positions and risk management practices; (iii) recovery and resolution preparedness; and (iv) governance and controls.<sup>2</sup> For large financial institutions that are not LISCC firms, the Federal Reserve performs horizontal reviews and firm-specific supervisory work focused on capital, liquidity, and governance and control practices, which are tailored to reflect the risk characteristics of these institutions.

Since 2004, the Federal Reserve has used the "RFI/C(D)" rating system (referred to as the "RFI rating system") to communicate its supervisory assessment of every bank holding company regardless of its asset size, complexity, or systemic importance.<sup>3</sup> The RFI rating system is focused on the risk management practices (R component) and financial condition (F component) of the consolidated organization, and includes an assessment of the potential impact (I component) of a bank holding company's nondepository entities on its subsidiary depository institution(s).

The Federal Reserve has not modified the RFI rating system to reflect the substantial changes to the statutory and regulatory framework relating to large financial institutions, or the

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<sup>2</sup> See the list of firms included in the LISCC supervisory program at <https://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm>.

<sup>3</sup> See SR letter 04-18, "Bank Holding Company Rating System," 69 FR 70444 (December 6, 2004), at <https://www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm>.

Concurrently with this final rule, the Federal Reserve is adopting a final rule to apply the RFI rating system on a fully implemented basis to all savings and loan holding companies (SLHCs) with total consolidated assets of less than \$100 billion, excluding SLHCs engaged in significant insurance or commercial activities. See [83 FR \_\_\_\_ (Date) cite to RFI SLHC rule]. The Federal Reserve had applied the RFI rating system to SLHCs on an indicative basis since assuming supervisory responsibility for those firms from the Office of Thrift Supervision in 2011.

Federal Reserve’s implementation of the LFI supervisory program in recent years. In light of these changes, the Board is adopting a new rating system applicable to these firms that is more closely aligned with the LFI supervisory program, so that the ratings more directly communicate the results of the Federal Reserve’s supervisory assessment.

Because the statutory, regulatory, and supervisory framework for community and regional bank holding companies has not undergone material changes since the financial crisis, the RFI rating system remains a relevant and effective tool for developing and communicating supervisory assessments for those firms. Therefore, the RFI rating system will continue to be used in the supervision of these organizations.

## **II. Notice of Proposed Rulemaking and Overview of Comments**

On August 17, 2017, the Board invited public comment on a notice of proposed rulemaking to adopt a new rating system for large financial institutions (proposed LFI rating system).<sup>4</sup> The proposed LFI rating system would have applied to bank holding companies and non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$50 billion or more, and U.S. intermediate holding companies (U.S. IHCs) of foreign banking organizations established under Regulation YY.<sup>5</sup>

Under the proposed LFI rating system, each banking organization would have been assigned ratings for three separate components: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. The ratings would have been assigned using a four-point non-numeric scale (Satisfactory/Satisfactory Watch, Deficient-1, and Deficient-2).<sup>6</sup> A firm would need a “Satisfactory” or “Satisfactory Watch” rating for each of the

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<sup>4</sup> 82 FR 39049 (August 17, 2017).

<sup>5</sup> 12 CFR 252.153.

<sup>6</sup> In the proposed LFI rating system, Satisfactory Watch was a subcategory of “Satisfactory.”

three component ratings to be considered “well managed” for various purposes under the Board’s rules and federal law. The proposal would not have included the assignment of a standalone composite rating or any subcomponent ratings. In addition, the proposal would have amended certain provisions of the Board’s existing regulations (Regulation K and Regulation LL) to make them compatible with the proposed rating scale.

The Board received 16 comments on the proposal from supervised firms, trade associations, industry consultants, and individuals. In addition, Federal Reserve staff held several meetings on the proposal with members of the public and obtained supplementary information from certain commenters. Summaries of these meetings are available on the Board’s public Web site.

Most commenters generally supported the proposal to develop a new rating system that would be aligned with the Federal Reserve’s LFI supervisory program. However, many commenters also expressed concerns regarding specific aspects of the proposal, including the applicability and implementation of the proposed LFI rating system and its underlying components, the lack of a standalone composite rating, the ratings scale, and the consequences of ratings assigned under the rating system.

Separately, the Board invited comment on two other proposals closely related to the proposed LFI rating system. The first proposal addressed proposed guidance on supervisory expectations for boards of directors, which set forth attributes of an effective board of directors of LFIs,<sup>7</sup> and the second proposal addressed an LFI’s management of business lines and

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<sup>7</sup> 82 FR 37219 (August 9, 2017).

independent risk management and controls.<sup>8</sup> The Board continues to consider comments on these proposals, and thus, is not adopting either proposal at this time.

### **III. Overview of Final Rule and Modifications from the Proposal**

The final rating system adopts the core elements of the proposed LFI rating system, with certain modifications to address commenter concerns. Consistent with the proposal, a banking organization will be assigned three component ratings: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. In addition, although the final LFI rating system retains a four-category, non-numeric rating scale, it identifies the top two categories as “Broadly Meets Expectations” and “Conditionally Meets Expectations” to align with the definitions of those categories.

### **IV. Final LFI Rating System**

#### **A. Applicability**

In the proposal, the LFI rating system would have applied to bank holding companies, non-insurance, non-commercial savings and loan holding companies, and U.S. IHCs of foreign banking organizations with \$50 billion or more in total consolidated assets. The Board received several comments regarding the applicability of the LFI rating system. For example, one commenter suggested that the Board should use risk-based factors instead of asset size to determine which firms are subject to the LFI rating system. Another commenter suggested that the \$50 billion threshold should be raised.

In addition to the comments received, the Board has taken into consideration that since the proposal, section 401 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) amended section 165 of the Dodd-Frank Wall Street Reform and Consumer

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<sup>8</sup> 83 FR 1351 (January 11, 2018).

Protection Act (Dodd-Frank Act) to modify the \$50 billion minimum asset threshold for general application of enhanced prudential standards.<sup>9</sup> Effective immediately on the date of its enactment, bank holding companies with total consolidated assets equal to or greater than \$50 billion and less than \$100 billion were no longer subject to these standards.<sup>10</sup>

In consideration of the comments received and the statutory changes under EGRRCPA, the final LFI rating system is being adopted for bank holding companies and, non-insurance and non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more, and for U.S. IHCs of foreign banking organizations established under Regulation YY with total consolidated assets of \$50 billion or more.<sup>11</sup> The decision to increase the asset threshold to \$100 billion for bank holding companies and non-insurance, non-

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<sup>9</sup> Public Law 115–174, section 401, 132 Stat. 1296 (2018).

<sup>10</sup> Section 401(f) of EGRRCPA also provides that any bank holding company, regardless of asset size, that has been identified as a Global Systemically Important Bank (GSIB) under the Board’s GSIB capital surcharge rule shall be considered a bank holding company with \$250 billion or more in total consolidated assets for purposes of applying the standards under section 165 and certain other provisions. EGRRCPA § 401.

The Board issued two statements – one individually, and the other jointly with the FDIC and OCC – that provided information on Board-administered regulations and associated reporting requirements that EGRRCPA immediately affected. *See* Board and Interagency statements regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), July 6, 2018, available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf>; <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf>. The statements describe interim positions that the Board and other agencies have taken until the agencies finalize amendments to their regulations to implement EGRRCPA.

<sup>11</sup> For a bank holding company and savings and loan holding company, total consolidated assets of \$100 billion or more will be calculated based on the average of the firm’s total consolidated assets in the four most recent quarters as reported on the firm’s quarterly financial reports filed with the Federal Reserve. A firm will continue to be rated under the final LFI rating system until it has less than \$95 billion in total consolidated assets, based on the average total consolidated assets as reported on the firm’s four most recent quarterly financial reports filed with the Federal Reserve. As noted in the proposal, the Federal Reserve may determine to apply the RFI rating system or another applicable rating system in certain limited circumstances.

SLHCs are considered to be engaged in significant commercial activities if they derive 50 percent or more of their total consolidated assets or total revenues from activities that are not financial in nature under section 4(k) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(k)). SLHCs are considered to be engaged in significant insurance underwriting activities if they are either insurance companies or hold 25 percent or more of their total consolidated assets in subsidiaries that are insurance companies. SLHCs that meet these criteria are excluded from the definition of “covered savings and loan holding company” in section 217.2 of the Board’s Regulation Q. *See* 12 CFR 217.2.



commercial SLHCs is consistent with the minimum threshold for enhanced prudential standards established by EGRRCPA as well as the Board's proposal to tailor certain of its regulations for domestic firms to implement EGRRCPA.<sup>12</sup> The Board has retained the asset threshold of \$50 billion for U.S. IHCs of foreign banking organizations as it continues to consider appropriate tailoring of its regulations for FBOs in light of EGRRCPA; however, the Board may adjust this asset threshold in the future if necessary.

Bank holding companies with total consolidated assets of at least \$50 billion but less than \$100 billion will continue to be evaluated subject to the RFI rating system. The Board is currently reviewing existing supervisory guidance with respect to these firms to determine whether it is appropriate to make revisions to further distinguish supervisory expectations for firms with total consolidated assets of less than \$100 billion.

The proposed LFI rating system would not have applied to SLHCs that are predominantly engaged in insurance or commercial activities. The Board continues to consider the appropriate regulatory regime for these firms. As such, the Board will continue to rate these SLHCs on an indicative basis under the RFI rating system as it considers further the appropriate manner to assign supervisory ratings to such firms on a permanent basis.<sup>13</sup>

## **B. Timing and Implementation**

Under the proposal, the initial set of LFI ratings would have been assigned starting in 2018. Several commenters provided views regarding the timing and implementation of the final LFI rating system. For instance, commenters suggested that Federal Reserve delay

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<sup>12</sup> [See 83 FR \_\_\_\_ (Date) cite to domestic tailoring proposal.]

<sup>13</sup> Concurrent with the issuance of this final LFI rating system, the Board adopted the RFI rating system for SLHCs that are depository in nature. *See supra* fn. 3. The RFI rating system will cease to apply to SLHCs with \$100 billion or more in total consolidated assets upon the effective date of LFI rating system for such firms. The Board also continues to consider the appropriate regulatory regime for systemically important nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Federal Reserve.

implementation of the LFI rating system for firms with assets of less than \$250 billion until the completion of regulatory reforms. Other commenters requested that the Board coordinate the implementation of the final LFI rating system with the related guidance setting forth attributes of effective boards and expectations for the management of business lines and independent risk management and controls, and the Federal Reserve provide more clarity regarding the implementation of the guidance.<sup>14</sup> Another commenter requested that the Federal Reserve run a pilot program before implementing the final LFI rating system.

In light of the changes to the application of enhanced prudential standards under EGRRCPA, the Board is currently considering ways to tailor the regulatory and supervisory framework for firms that are not in the LISCC portfolio. Accordingly, in order to conduct that review and seek public comment on any proposed revisions to the Board's regulations, the Federal Reserve will continue to use the RFI rating system for ratings in 2019 for holding companies with assets of \$100 billion or more and U.S. intermediate holding companies of foreign banking organizations that are not subject to the LISCC framework. The Federal Reserve will assign ratings using the final LFI rating system beginning in early 2020.<sup>15</sup>

For bank holding companies and U.S. IHCs of foreign banking organizations subject to the LISCC framework, the Federal Reserve will begin assigning ratings using the final LFI rating system in early 2019. In early 2019, LISCC firms will receive all three component ratings under the LFI rating system; following the initial rating assignment, updates to individual rating

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<sup>14</sup> Comments related to implementation of the LFI rating system for FBOs are discussed below.

<sup>15</sup> In early 2020, banking organizations that are not LISCC firms will receive all three component ratings under the LFI rating system; following the initial rating assignment, updates to individual rating components may be assigned and communicated to the firm on a rolling basis, but at least annually.

components may be assigned and communicated to the firm on a rolling basis, but at least annually.

The Board believes that it is important to have the LFI rating system become effective soon in order to align the supervisory rating system with the Board's current consolidated supervisory framework for large financial institutions. This alignment will enhance the clarity of the Board's supervisory program, as both the Board's supervisory assessment of a firm and its related assignment of the firm's ratings will directly relate with the three core areas of focus in the consolidated supervisory framework: capital, liquidity, and governance and controls. For example, supervisory assessments of a firm's capital and liquidity can be prominently reflected in the ratings assigned under the LFI rating system, whereas such assessments are less easily communicated within the structure of the RFI rating system. To ensure that ratings are assigned in a consistent and fair manner, the Federal Reserve is implementing staff training and will undertake a multi-level review and vetting before ratings are assigned.

As noted above, the Board invited comment on two sets of guidance that related to the governance and controls component rating—the first established principles regarding effective boards of directors focused on the performance of a board's core responsibilities, and the second set forth core principles of effective senior management, the management of business lines, and independent risk management and controls for large financial institutions. The Board continues to consider comments on both proposals, and thus, is not adopting either set of guidance at this time. Given that the guidance establishing principles regarding effective boards of directors is not finalized, the Federal Reserve intends to rely primarily on principles set forth in SR letter 12-17/CA letter 12-14 and safety and soundness to assess the effectiveness of a firm's board of directors. Given that the management of business lines and independent risk management and

controls guidance is not finalized, the Federal Reserve will rely on existing risk management guidance to assess the effectiveness of a firm's management of business lines and independent risk management and controls.<sup>16</sup>

### ***Reliance on other regulators***

Commenters requested that the Federal Reserve rely to a greater extent on the supervisory evaluations conducted by other regulators, including both domestic and foreign supervisors. Coordination with other domestic regulators and foreign supervisory authorities is a critical component of the LFI supervisory program. Federal Reserve staff meets regularly with counterparts at domestic and foreign regulatory agencies that have primary supervisory responsibility with respect to a banking organization or its subsidiaries, or its foreign bank parent, in order to leverage work and ensure effective coordination. In assigning LFI component ratings under the final LFI rating system, the Federal Reserve will continue to rely to the fullest extent possible on applicable information and assessments developed by other relevant supervisors and functional regulators.

### ***Application to U.S. IHCs***

The proposed LFI rating system would have applied to U.S. IHCs of foreign banking organizations. Some commenters requested that the Board delay application of the LFI rating

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<sup>16</sup> Existing risk management guidance includes, but is not limited to, SR letter 95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies;" SR letter 03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing;" SR letter 12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions;" SR letter 10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management;" SR letter 13-1/CA letter 13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing;" SR letter 13-19/CA letter 13-21, "Guidance on Managing Outsourcing Risk;" SR letter 15-18, "Supervisory Assessment of Capital Planning and Positions for LISCC Firms and Large and Complex Firms;" and SR letter 15-19, "Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms." In addition, Regulation YY sets forth risk management requirements, including liquidity risk management requirements.

system to U.S. IHCs until the Board sought comment on governance and controls guidance designed specifically for U.S. IHCs. Commenters requested clarification on how the assignment of LFI ratings to U.S. IHCs would interact with other ratings assigned to the U.S. operations of foreign banking organizations (the combined U.S. operations assessment) and the ROCA rating for U.S. branches and agencies.

Under the principle of national treatment, the Federal Reserve generally applies standards to the U.S. operations of a foreign banking organization consistent with those that apply to similarly situated U.S. banking organizations. The U.S. operations of a foreign banking organization are subject to regulatory standards set forth in Regulation YY, and expectations related to capital planning and positions, liquidity risk management and positions, and governance and controls, that are parallel to those that apply to a U.S. bank holding company. Applying the final LFI rating system to U.S. IHCs of foreign banking organizations would be consistent with national treatment and the Board's approach to regulating and supervising foreign banking organizations.

As commenters note, the Board did not apply the guidance setting forth attributes of effective boards to U.S. IHCs, in recognition of the fact that a U.S. IHC is a subsidiary of a foreign banking organization. U.S. IHCs will not be subject to examinations solely focused on effectiveness of the U.S. IHC's board of directors.<sup>17</sup> Rather, the Federal Reserve will indirectly assess the effectiveness of a U.S. IHC's board by considering whether weaknesses or deficiencies that are identified within the organization while conducting other supervisory work may be evidence of, or resulting from, governance-related oversight deficiencies. For example,

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<sup>17</sup> However, the Federal Reserve may consider the effectiveness of the IHC's board of directors in connection with other examinations. For example, the Federal Reserve may consider governance-related oversight deficiencies in the context of a significant risk management or control weakness that is identified during an examination of capital planning or business line management.

governance-related oversight deficiencies could be noted in the context of a significant risk management or control weakness that is identified during an examination of capital planning or business line management.

The Board will continue to evaluate the U.S. branches of foreign banks under the ROCA system, and assign a single component rating to the foreign banking organization's U.S. operations. As noted in the preamble to the proposal, the Board is considering adjustments to the ratings for U.S. branches and the U.S. operations to better align with the LFI framework.

Commenters also requested clarity in how the LFI rating would impact the "well managed" status of a foreign banking organization that is a financial holding company. Under current law, a foreign banking organization that is a financial holding company must be well capitalized and must have a satisfactory composite rating of its U.S. branch and agency operations and a satisfactory rating of its U.S. combined operations, if one is given. As with the rating currently assigned to a U.S. IHC under the RFI system, the LFI rating assigned to the U.S. IHC would be an input into the rating of the combined U.S. operations of a foreign bank.

### **C. LFI Rating Components**

Under the proposed LFI rating system, the Federal Reserve would have evaluated and assigned ratings for the following three components: Capital Planning and Positions; Liquidity Risk Management and Positions; and Governance and Controls. The final LFI rating system adopts these component categories as proposed.

#### ***Capital Planning and Positions***

As proposed, the Capital Planning and Positions rating would have encompassed assessments of (i) the effectiveness of the governance and planning processes used by a firm to determine the amount of capital necessary to cover risks and exposures, and to support activities

through a range of conditions; and (ii) the sufficiency of a firm's capital positions to comply with applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

Several commenters sought clarification regarding the relationship between a firm's compliance with regulatory capital requirements and a firm's Capital Planning and Positions rating. In addition, some commenters asserted that receipt of a non-objection to a capital plan should result in (or create the presumption of) a firm receiving a "Satisfactory" rating for the Capital Planning and Positions component under the LFI rating system.

The final LFI rating system adopts the description of the Capital Planning and Positions component rating used in the proposal. A firm's capital rating under the LFI rating system will reflect a broad assessment of the firm's capital planning and positions, based on horizontal reviews and firm-specific supervisory work focused on capital planning and positions. In consolidating supervisory findings into a comprehensive assessment of a firm's capital planning and positions, the Federal Reserve will take into account the materiality of a firm's outstanding and newly identified supervisory issues.

A firm's compliance with minimum regulatory capital requirements will be considered in assigning the firm's Capital Planning and Positions component rating; however, the Federal Reserve may determine that a firm does not meet expectations regarding its capital position in light of its idiosyncratic activities and risks, even if the firm meets minimum regulatory capital requirements. Any findings from supervisory stress testing, such as CCAR or similar activities, will represent inputs into the Capital Planning and Positions component rating. However, with respect to any firm that may be subject to a qualitative review of its capital planning practices, there is no automatic link between the results of that review and the firm's capital rating.

Some commenters argued that the Board should discontinue its practice of publicly objecting or not-objecting to a firm's capital plan. Last year, the Board exempted firms with less than \$250 billion in assets and less than \$75 billion in nonbank assets from the CCAR qualitative assessment, and in the recent stress capital buffer proposal, the Board sought comments on potential changes to the CCAR qualitative assessment.<sup>18</sup> The Board is currently in the process of evaluating these comments.

In addition, commenters noted that the Board should clarify that the final LFI rating system does not create any new qualitative standards for capital planning, and others requested that the Board separately seek comment on the capital planning expectations included in SR letters 15-18 and 15-19. Consistent with the commenters' request, the Board confirms that the final LFI rating system does not create any new capital planning expectations applicable to LFIs. When the Board adopted SR letters 15-18 and 15-19, it did not seek comment on those letters, as they largely consolidated the Federal Reserve's existing capital planning guidance in one place. To the extent the Board considers adjustments to those letters in the future, the Board will take commenters' views into account.

### ***Liquidity Risk Management and Positions***

As proposed, the Liquidity Risk Management and Positions component rating would have encompassed assessments of (i) the effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (ii) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

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<sup>18</sup> 83 FR 9308 (February 3, 2017); 83 FR 18160 (April 25, 2018).



Several commenters requested that the Board clarify how the liquidity rating would be assigned and clarify the linkage between a firm's rating and its compliance with the minimum liquidity requirements. The final ratings system adopts the description of the Liquidity Risk Management and Positions component rating used in the proposal without change. In assessing the liquidity risk management and position of a banking organization, the Federal Reserve evaluates each firm's risk management practices by reviewing the processes that firms use to identify, measure, monitor, and manage liquidity risk and make funding decisions, and evaluating the firm's compliance with the liquidity risk management requirements of Regulation YY. The Federal Reserve evaluates a firm's liquidity positions against applicable regulatory requirements, and assesses the firm's ability to support its obligations through other means, such as its funding concentrations. A firm's liquidity rating will reflect the materiality of issues identified through the supervisory process.

In addition, commenters requested additional detail on the relationship between the Liquidity Risk Management and Positions rating of a LISCC firm and its performance in the Comprehensive Liquidity Assessment Review (CLAR). As for all component ratings, horizontal and firm-specific examination work conducted under the LISCC liquidity program, which is inclusive of the horizontal work covered under the CLAR, will represent a material input into a firm's liquidity rating. Unlike CCAR, the LISCC liquidity program's assessment does not result in an objection or non-objection ; rather, it results in supervisory findings communicated to the firm, which may include "matters requiring attention" and "matters requiring immediate attention," as applicable.

## ***Governance and Controls***

The proposed Governance and Controls component rating would have evaluated the effectiveness of a firm’s (i) board of directors,<sup>19</sup> (ii) management of business lines and independent risk management and controls,<sup>20</sup> and (iii) recovery planning (for domestic LISCC firms only).<sup>21</sup>

This component rating would have included consideration of a firm’s compliance practices. One commenter suggested that the rating take into account only compliance matters that would have a material impact on a firm’s financial and operational strength and resiliency. The Board expects all firms to comply fully with applicable laws and regulations, including those related to consumer protection. In assigning a supervisory rating, the Board will take into account the materiality of outstanding and identified supervisory issues, including the extent to which a matter would have a material impact on a firm’s financial and operational strength and resiliency.

The proposed Governance and Controls component rating would have included a consideration of recovery planning for domestic LISCC firms, given the heightened risks that LISCC firms present to financial stability. One commenter suggested that the governance and controls rating not include recovery planning for domestic LISCC firms, because related

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<sup>19</sup> “Board” or “board of directors” also refers to the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.

<sup>20</sup> The final LFI rating system uses the term “management of business lines” instead of “management of core business lines,” in order to align with the proposed guidance on the management of business lines and independent risk management and controls.

<sup>21</sup> At this time, recovery planning expectations only apply to domestic bank holding companies subject to the Federal Reserve’s LISCC supervisory framework. *See* SR letter 14-8, “Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies.” Should the Federal Reserve expand the scope of recovery planning expectations to encompass additional firms, this rating will reflect such expectations for the broader set of firms.

There are eight domestic firms in the LISCC portfolio: (1) Bank of America Corporation; (2) Bank of New York Mellon Corporation; (3) Citigroup, Inc.; (4) Goldman Sachs Group, Inc.; (5) JP Morgan Chase & Co.; (6) Morgan Stanley; (7) State Street Corporation; and (8) Wells Fargo & Company.

supervisory expectations are already reflected in other aspects of the LFI rating system. The final LFI rating system maintains consideration of recovery planning in assessing the governance and controls of a LISCC firm, as effective recovery planning practices are central to ensuring that a LISCC firm has sufficient financial and operational strength to continue operations through a range of conditions.

The Board requested comment on whether resolution planning should also be a component of, or otherwise factored into, the LFI rating system. Several commenters argued against inclusion of resolution planning, stating, for example, that adding a separate component rating for resolution planning would be duplicative in light the current public deficiency findings under the resolution plan rule. One commenter supported the inclusion of resolution planning in the LFI rating system.

The Board has determined not to include a separate component rating for a firm's resolution planning as part of the final LFI rating system. The Board will continue to consider whether the LFI rating system should be modified in the future to include an assessment of the sufficiency of a firm's resolution planning efforts.

#### **D. LFI Rating Scale**

Under the proposed LFI rating system, ratings would have been assigned based on a four-point scale, with the following categories: *Satisfactory/Satisfactory Watch*, *Deficient-1*, and *Deficient-2*. One commenter expressed concern that the reduction in the number of ratings categories from five, as in the current RFI framework, to four, would result in the new rating framework being less flexible and nuanced, and lead to inadvertent rating downgrades.

A four-category rating scale is intended to increase the usability of the scale – under the RFI rating system, the highest rating of “1” and the lowest rating of “5” were rarely used when

rating LFIs. Further, the “Conditionally Meets Expectations” rating category enables the Federal Reserve to identify certain material issues at a firm and provide a firm with notice and the ability to fix those issues before the firm experiences regulatory consequences as a result of the ratings downgrade.

The final LFI rating system adopts a similar four-category scale, but uses different terminology to improve the descriptiveness of the rating categories. Specifically, the final rating categories are: *Broadly Meets Expectations*, *Conditionally Meets Expectations*, *Deficient-1*, and *Deficient-2*. The final LFI rating system also clarifies the definitions within each category to provide additional guidance to examiners and provide transparency to firms about the calibration of each category.

Several commenters also expressed the need for the use of additional quantitative measures improve transparency and consistency in how ratings are derived. The Federal Reserve will continue to use quantitative measures, together with supervisory judgment, to inform a comprehensive assessment of a firm’s Capital, Liquidity, and Governance and Controls.

### ***Broadly Meets Expectations***

In the proposal, the highest rating category was “Satisfactory.” A “Satisfactory” rating would have indicated that a firm is considered safe and sound and broadly meets supervisory expectations.

The final LFI rating system renames the rating category as “Broadly Meets Expectations,” to align more closely with the underlying definition of the rating category.<sup>22</sup> As with the proposal, the final ratings definition for “Broadly Meets Expectations” provides that a

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<sup>22</sup> References to “safe and sound” or “safety and soundness” in the LFI rating system apply to a firm’s consolidated organization as well as to its critical operations and banking offices.

firm may have supervisory issues requiring corrective action; however, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of conditions.

Two commenters suggested that the rating scale should include a higher rating above the "Satisfactory" designation, similar to the "Strong" rating utilized with the RFI, CAMELS, and other supervisory rating systems. The final LFI rating system does not include a "Strong" rating, which may suggest that the Federal Reserve expects firms to exceed, not simply meet, supervisory expectations. In addition, a "Strong" rating would not enhance or clarify supervisory communications, as a "Strong" rating would have no supervisory consequences.<sup>23</sup>

One commenter stated that the rule should clarify the circumstances under which MRAs or MRIAs would trigger a downgrade from the "Satisfactory" rating. As noted above, in consolidating supervisory findings into a comprehensive assessment in each category, the Board will take into account the materiality of a firm's outstanding and newly identified supervisory issues. While a given ratings assessment will depend on the circumstances, the LFI rating scale is designed to clarify the relationship between supervisory issues and deficiencies, and a firm's progress in remediation and mitigation efforts.

#### ***Conditionally Meets Expectations***

In the proposed LFI rating system, the second highest rating category was "Satisfactory Watch." This rating would have indicated that a firm was generally considered safe and sound; however, certain issues were sufficiently material that, if not resolved in a timely manner in the normal course of business, they would put the firm's prospects for remaining safe and sound

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<sup>23</sup> One comment requested removal of the term "strong," which was used to describe practices related to controls. To provide the clarity requested by the commenter, the final terminology has been changed to use the term "effective."

through a range of conditions at risk. As noted in the proposal, the “Satisfactory Watch” rating was intended to be consistent with the Federal Reserve’s practice of providing notice to firms that they are likely to be downgraded if identified weaknesses are not resolved in a timely manner.

The preamble to the proposal noted that the “Satisfactory Watch” rating was not intended to be used for a prolonged period; rather, firms would have had a specified timeframe to fully resolve issues leading to that rating (as is the case with all supervisory issues), but generally no longer than 18 months. Several commenters noted that many supervisory issues take longer than 18 months to resolve, and that resolution of certain issues requires substantial infrastructure investment and changes in processes and controls. As such, these commenters argued that the specified remediation timeframes in the “Satisfactory Watch” rating should be based on the specific facts and circumstances of the supervisory issue(s) in question, rather than limited to an 18-month period. These commenters also argued that a firm should not be downgraded provided the firm makes good faith efforts to remediate the issues and progress is made.

As in the proposal, the final ratings framework states that the Federal Reserve does not intend for a firm to be rated “Conditionally Meets Expectations” for a prolonged period. However, unlike the proposal, the final ratings framework does not establish a fixed timeline for how long a firm can be rated “Conditionally Meets Expectations.” Instead, the final ratings framework reflects an understanding that timelines will be issues-specific, noting that the Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be expected to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating. Further, the final ratings framework reflects an understanding that completion and validation of remediation activities for selected supervisory issues – such as

those involving information technology modifications – will require an extended time horizon. In all instances, appropriate and effective risk mitigation techniques must be utilized in the interim to maintain safe-and-sound operations under a range of conditions until remediation activities are completed, validated, and fully operational.

One commenter recommended that the “Satisfactory Watch” rating should be permanent, rather than temporary, while another argued that the “Satisfactory Watch” rating should be used infrequently. The final LFI rating system acknowledges there are circumstances when a firm may be rated “Conditionally Meets Expectations” for a longer period of time if, for instance, the firm is close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues may be identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

The proposal would have provided that “Satisfactory Watch” would be appropriate when a firm could resolve the issue in a timely manner in the normal course of business. Commenters requested clarification on expectations regarding “normal course of business.” The final LFI rating system clarifies that “normal course of business” means that a firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management, or internal control structures or practices.

Several commenters also argued that a firm rated “Deficient” should be upgraded to the “Satisfactory Watch” rating if the firm has remediated identified deficiencies but a validation

process had not yet been completed. As indicated in the Deficient-1 section below, the final LFI framework indicates that a firm previously rated “Deficient” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that its prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

### ***Deficient-1***

In the proposal, the third rating category was “Deficient-1,” which would have indicated that, although the firm’s current condition is not considered to be materially threatened, there were financial and/or operational deficiencies that put its prospects for remaining safe and sound through a range of conditions at significant risk. The final ratings framework maintains the name of the third rating category.

Under the proposed LFI rating system, a firm that received a rating of “Deficient-1” or “Deficient-2” in any component rating would not be considered “well managed” for purposes of the Bank Holding Company Act (BHC Act).<sup>24</sup> Several commenters suggested that the “well managed” determination should be made on the basis of an assessment of the firm as a whole, rather than the automatic consequence of any one component rating. One commenter argued that the separate, standalone composite rating should form the sole basis for determining a firm’s “well managed” status.

Conditioning a firm’s “well managed” status on all three rating categories reflects the judgment that a banking organization is not in satisfactory condition overall unless it is

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<sup>24</sup> For purposes of determining whether a firm is considered to be “well managed” under section 2(o)(9) of the BHC Act, the Federal Reserve considers the three component ratings, taken together, to be equivalent to assigning a standalone composite rating. In addition, the RFI rating system designates the “Risk Management” rating as the “management” rating when making “well managed” determinations under section 2(o)(9)(A)(ii) of the BHC Act. *See* SR letter 04-8. In contrast, the LFI rating system would not designate any of the three component ratings as a “management” rating, because each component evaluates different areas of the firm’s management.



considered sound in each of the key areas of capital, liquidity, and governance and controls. Each rating category includes assessments of key aspects of a firm's practices and capabilities, including management, that are necessary to operate in a safe-and-sound manner. A "Deficient" rating in any of the components reflects the supervisory conclusion that financial or operational deficiencies have placed the firm's safety and soundness at significant risk, which would not warrant a firm being deemed "well managed." Accordingly, the final LFI rating system maintains the proposed approach to determining whether a firm is "well managed."

Under current law, a firm must receive a "Satisfactory" risk management and composite rating in order to qualify as "well managed." Several commenters argued that the proposed rating scale would introduce a more rigid standard compared with the RFI rating system, potentially making LFIs less likely to be considered "well managed." In the Board's view, any rigidity is balanced by the introduction of the "Conditionally Meets Expectations" rating, which provides notice to firms that they are likely to be downgraded if identified weaknesses are not resolved in a timely manner.

The proposal noted that a "Deficient-1" component rating would often be an indication that the firm should be subject to either an informal or formal enforcement action, and may also result in the designation of the firm as being in "troubled condition."<sup>25</sup> Several commenters requested clarity under what circumstances a "Deficient-1" rating would result in "troubled condition" status or a formal enforcement action.

Consistent with commenters' views, the final LFI rating system reflects that there is no presumption that a firm rated "Deficient-1" would be deemed to be in "troubled condition."

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<sup>25</sup> See 12 CFR 225.71(d).

Whether a firm rated “Deficient-1” receives a “troubled condition” designation will be determined by the facts and circumstances at that firm. However, firms rated “Deficient-1” due to financial weaknesses in either capital or liquidity would be more likely to be deemed in “troubled condition” than firms rated “Deficient-1” due solely to issues of governance or controls.

While a commenter asked that a “Deficient-1” rating be an automatic bar to new or expansionary activity, others suggested that firms rated “Deficient-1” not be subject to any restrictions on growth. Consistent with the proposal, receiving a “Deficient-1” rating under the final LFI rating system would result in automatic consequences for a firm’s “well managed” status, which would limit the firm’s ability to engage in new or expansionary nonbanking activities. Further, as with the proposal, a “Deficient-1” rating in the final LFI rating system could be a barrier for a firm seeking the Federal Reserve’s approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the firm from remediating current deficiencies or issues.

### ***Deficient-2***

A “Deficient-2” rating indicates that financial and/or operational deficiencies materially threaten the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition. The proposal noted that a firm with a “Deficient-2” component rating would be required to immediately (i) implement comprehensive corrective measures sufficient to restore and maintain appropriate capital planning capabilities and adequate capital positions; and

(ii) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. It also noted that there is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve, and that the Federal Reserve would be unlikely to approve a proposal from a firm to engage in new or expansionary activities.

The final LFI rating system adopts the “Deficient-2” ratings category without change.

## **E. General Comments**

### ***Eliminating Subcomponent Ratings***

The proposed LFI rating system described the areas of assessment under each component rating, but would not have assigned separate subcomponents for each area of assessment. A few commenters recommended that each of the three component ratings include subcomponent ratings, as used in the RFI rating system. These commenters argued that subcomponent ratings aid supervisory staff to consistently apply the component rating across institutions, and allow firms to more easily identify, communicate, and correct deficiencies across the organization.

Communicating a single rating in each component is intended to reinforce the Board’s view that the strength of a firm’s capital and liquidity position is integrated with the effectiveness of the firm’s capital planning and liquidity risk management, respectively, and the strength of a firm’s risk management depends on the effectiveness of the board oversight. In developing the rating, the Federal Reserve will rely on firm-specific and horizontal examination work.

Throughout the year, and in connection with its rating, firms will receive feedback relating to the supervisory activities that inform the ratings, which will provide firms with specific feedback relating to the elements of the rating.

### ***Composite Rating***

Several commenters asserted that the LFI rating system should include a separate, standalone composite rating in addition to the three component ratings. These commenters asserted that a composite rating would provide a fuller view of the health of each institution.

Unlike other supervisory rating systems, including the RFI rating system, the Federal Reserve will not assign a standalone composite rating under the LFI rating system. As noted in the proposal, assigning a standalone composite rating is not necessary because the three component ratings are designed to clearly communicate supervisory assessments and associated consequences for each of the core areas (capital, liquidity, and governance and controls). Further, the components identify those core areas that are necessary and critical to a firm's strength and resilience. It is unlikely that the assignment of a standalone composite rating would convey new or additional information regarding these supervisory assessments not already communicated by the three component ratings, and a standalone composite rating could dilute the clarity and impact of the component ratings. As such, the final LFI rating system does not include a separate standalone composite rating.

### ***Disclosure and Challenge to Ratings***

In accordance with the Federal Reserve's regulations governing confidential supervisory information,<sup>26</sup> ratings assigned under the proposed LFI rating system would have been communicated by the Federal Reserve to the firm but not disclosed publicly. One commenter requested that LFI rating components be publicly disclosed, as the public would benefit from additional supervisory disclosure regarding individual firms. The Board has traditionally maintained the confidentiality of supervisory ratings in order to preserve candor in

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<sup>26</sup> See 12 CFR 261.20.

communication between supervised institutions and the Board. For this reason, in accordance with the Federal Reserve's regulations governing confidential supervisory information, ratings assigned under the LFI rating system will be communicated by the Federal Reserve to the firm, but individual ratings will not be disclosed publicly. The Federal Reserve will continue to think broadly in considering ways to enhance transparency across its processes and communications in support of improved supervisory approaches and outcomes.

In addition, some commenters indicated that there should be a more effective process for firms to challenge and seek review of supervisory findings, such as additional opportunities to respond to adverse findings by examiners, and meetings with the Federal Reserve. The Federal Reserve is committed to engaging in ongoing dialogue with banking organizations regarding supervisory findings to ensure that firms understand supervisory expectations and that the Federal Reserve understands the way that firms think about their business and risks. The Board also is committed to maintaining an effective independent appellate process to allow institutions to seek review of material supervisory determinations. The Board recently issued a proposal that is out for comment and is currently considering comments on that proposal.<sup>27</sup>

## **V. Changes to Existing Regulations**

References to holding company ratings are included in a number of the Federal Reserve's existing regulations. In certain cases, the regulations are narrowly constructed such that they contemplate only the assignment of a standalone composite rating using a numerical rating scale. This is consistent with the current RFI rating system but is not compatible with the LFI rating system. Three provisions in the Federal Reserve's existing regulations are written in this manner, including two in Regulation K and one in Regulation LL.

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<sup>27</sup> See 83 FR 8391 (February 27, 2018).

In Regulation K, section 211.2(z) includes a definition of “well managed” which, in part, requires a bank holding company to have received a composite rating of 1 or 2 at its most recent examination or review; and section 211.9(a)(2) requires an investor (which by definition can be a bank holding company) to have received a composite rating of at least 2 at its most recent examination in order to make investments under the general consent or limited general consent procedures contained in sections 211.9(b) and (c).

In Regulation LL, section 238.54(a)(1) restricts savings and loan holding companies from commencing certain activities without the Federal Reserve’s prior approval unless the company received a composite rating of 1 or 2 at its most recent examination.

To ensure that the Federal Reserve’s regulations are consistent and compatible with all aspects of both the RFI rating system as well as the LFI rating system, the Federal Reserve is amending those three regulatory provisions so that they will apply to entities which receive numerical composite ratings as well as to entities which do not receive numerical composite ratings (including firms subject to the LFI rating system).<sup>28</sup> To satisfy the requirements of those provisions, firms that do not receive numerical composite ratings will have to be considered satisfactory under the LFI rating system. To be considered satisfactory, a firm would have to be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each component of the LFI rating system; a firm which is rated “Deficient-1” or lower for any component would not be considered satisfactory. This standard applies to any provision contained in the Federal Reserve’s regulations, which requires or refers to a firm having a satisfactory composite rating.

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<sup>28</sup> The Board may propose additional necessary revisions to its regulations resulting from the adoption of a final LFI rating system.

## VI. Comparison of the RFI and LFI Rating Systems

As compared to the RFI rating system, the proposed LFI rating system did not include an explicit assessment of a banking organization’s ability to protect depository institutions from the activities of non-depository or capital market subsidiaries. The commenter suggested the Board revise the proposal to recognize the importance of this concept.

In response to the commenter, the final LFI rating system acknowledges that a banking organization is expected to ensure that the consolidated organization, including its critical operations and banking offices, remains safe and sound through a range of potentially stressful conditions.

The final LFI rating system includes several structural changes from the RFI rating system. The following table provides a broad comparison between the two rating systems.

RFI Rating System	LFI Rating System
<p><b>R – Risk Management</b></p> <p>An evaluation of the ability of the bank holding company’s board of directors and senior management to identify, measure, monitor, and control risk.</p> <p>The rating is supported by four subcomponent ratings:</p> <ul style="list-style-type: none"> <li>• Board and Senior Management Oversight</li> <li>• Policies, Procedures, and Limits</li> <li>• Risk Monitoring and Management Information Systems</li> <li>• Internal Controls</li> </ul>	<p>Assessment of the effectiveness of a firm’s governance and risk management practices is central to the Governance and Controls component rating. The Governance and Controls component rating evaluates a firm’s effectiveness in aligning strategic business objectives with risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.</p> <p>Governance and risk management practices specifically related to maintaining financial strength and resilience are also incorporated into the Capital Planning and Positions and Liquidity Risk Management and Positions component ratings.</p>
<p><b>F – Financial Condition</b></p> <p>An evaluation of the consolidated organization’s financial strength.</p>	<p>Assessment of a firm’s financial strength and resilience is specifically evaluated through the Capital Planning and Positions and Liquidity Risk Management and Positions component ratings.</p>

RFI Rating System	LFI Rating System
<p>The rating is supported by four subcomponent ratings:</p> <ul style="list-style-type: none"> <li>• Capital Adequacy</li> <li>• Asset Quality</li> <li>• Earnings</li> <li>• Liquidity</li> </ul>	<p>These component ratings also assess the effectiveness of associated planning and risk management processes, and the sufficiency of related positions.</p> <p>Although asset quality and earnings are not rated separately, they continue to be important elements in assessing a firm’s safety and soundness and resiliency, and are important considerations within each of the LFI component ratings.</p>
<p><b>I – Impact</b></p> <p>An assessment of the potential impact of the firm’s nondepository entities on its subsidiary depository institution(s).</p>	<p>Although a separate “Impact” rating will not be assigned, the LFI rating system will assess a firm’s ability to protect the safety and soundness of its subsidiary depository institutions, including whether the firm can provide financial and operational strength to its subsidiary depository institutions.<sup>29</sup></p>
<p><b>D – Depository Institutions</b></p> <p>Generally reflects the composite CAMELS rating assigned by the primary supervisor of the subsidiary depository institution(s).<sup>30</sup></p>	<p>The LFI rating system would not assign a separate rating for a firm’s depository institution subsidiaries. The Federal Reserve will continue to rely to the fullest extent possible on supervisory assessments developed by the primary supervisor of the subsidiary depository institution(s).</p>
<p><b>C – Composite Rating</b></p> <p>The overall composite assessment of the bank holding company as reflected by the R, F, and I ratings, and supported by examiner judgment with respect to the relative importance of each component to the safe and sound operation of the bank holding company.</p>	<p>A standalone composite rating will not be assigned. The three LFI component ratings are designed to clearly communicate supervisory assessments and associated consequences for each of the core areas (capital, liquidity, and governance and controls) that are considered critical to an LFI’s strength and resilience.</p> <p>For purposes of determining whether a firm is “well managed,” each component must be rated either “Broadly Meets Expectations” or “Conditionally Meets Expectations” in order for a firm to be deemed “well managed.”</p>

<sup>29</sup> See Sections 616 of Dodd-Frank Act (financial strength), 12 CFR 225.4 of the Board’s Regulation Y, and 12 CFR 238.8 of the Board’s Regulation LL.

<sup>30</sup> See SR letter 96-38, “Uniform Financial Institutions Rating System,” at <http://www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm>.



## **VII. Regulatory Analysis**

### **A. Paperwork Reduction Act**

There is no collection of information required by this proposal that would be subject to the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 *et seq.*

### **B. Regulatory Flexibility Analysis**

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 *et seq.*, generally requires that, in connection with a proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis (IRFA). The Board solicited public comment on the LFI rating system in a notice of proposed rulemaking and has since considered the potential impact of this final rule on small entities in accordance with section 604 of the RFA. Based on the Board's analysis, and for the reasons stated below, the Board believes the final rule will not have a significant economic impact on a substantial number of small entities.

The RFA requires an agency to prepare a final regulatory flexibility analysis (FRFA) unless the agency certifies that the rule will not, if promulgated, have a significant economic impact on a substantial number of small entities. The FRFA must contain: (1) a statement of the need for, and objectives of, the rule; (2) a statement of the significant issues raised by the public comments in response to the IRFA, a statement of the agency's assessment of such issues, and a statement of any changes made in the proposed rule as a result of such comments; (3) the response of the agency to any comments filed by the Chief Counsel for Advocacy of the Small Business Administration in response to the proposed rule, and a detailed statement of any changes made to the proposed rule in the final rule as a result of the comments; (4) a description of an estimate of the number of small entities to which the rule will apply or an

explanation of why no such estimate is available; (5) a description of the projected reporting, recordkeeping and other compliance requirements of the rule, including an estimate of the classes of small entities which will be subject to the requirement and type of professional skills necessary for preparation of the report or record; and (6) a description of the steps the agency has taken to minimize the economic impact on small entities, including a statement for selecting or rejecting the other significant alternatives to the rule considered by the agency.

The final rule adopts a new holding company rating system for large financial institutions, and amend the Board's Regulations K and LL to ensure the Board's regulations are compatible with all aspects of the LFI rating system, but will not change the operation of those regulations for any entity that is not subject to the LFI rating system. Commenters did not raise any issues in response to the IRFA. In addition, the Chief Counsel for Advocacy of the Small Business Administration did not file any comments in response to the proposed rule.

Under regulations issued by the Small Business Administration (SBA), a "small entity" includes a depository institution, bank holding company, or savings and loan holding company with assets of \$550 million or less (small banking organizations). As discussed in the SUPPLEMENTARY INFORMATION, the final rule will apply to all bank holding companies with total consolidated assets of \$100 billion or more; all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more; and U.S. intermediate holding companies of foreign banking organizations with total consolidated assets of \$50 billion or more.

Companies that are subject to the final rule therefore substantially exceed the \$550 million asset threshold at which a banking entity is considered a "small entity" under SBA

regulations. Because the final rule does not apply to any company with assets of \$550 million or less, the final rule would not apply to any “small entity” for purposes of the RFA.

There are no projected reporting, recordkeeping, or other compliance requirements associated with the final rule. As discussed above, the final rule does not apply to small entities.

The Board does not believe that the final rule duplicates, overlaps, or conflicts with any other Federal Rules. In addition, the Board does not believe there are significant alternatives to the final rule that have less economic impact on small entities. In light of the foregoing, the Board does not believe the final rule will have a significant economic impact on a substantial number of small entities.

### **C. Solicitation of Comments on Use of Plain Language**

Section 722 of the Gramm-Leach-Bliley Act requires the Board to use plain language in all proposed and final rules published after January 1, 2000. The Board received no comments on these matters and believes that the final rule is written plainly and clearly.

## **VIII. List of Subjects**

### **12 CFR Part 211**

**Exports, Federal Reserve System, Foreign banking, Holding companies, Investments, Reporting and recordkeeping requirements.**

### **12 CFR Part 238**

**Administrative practice and procedure, Banks, Banking, Federal Reserve System, Holding companies, Reporting and recordkeeping requirements.**

### **Authority and Issuance**

For the reasons stated in the preamble, the Board proposes to amend 12 CFR parts 211 and 238 as follows:

### **PART 211—INTERNATIONAL BANKING OPERATIONS (REGULATION K)**

- 1. The authority citations for part 211 continues to read as follows: 12 U.S.C. 221 et seq., 1818, 1835a, 1841 et seq., 3101 et seq., 3901 et seq., and 5101 et seq.; 15 U.S.C. 1681s, 1681w, 6801 and 6805.
- 2. Section 211.2 is amended by revising paragraph (z) to read as follows:

**§ 211.2 Definitions.**

\* \* \* \* \*

(z) *Well managed* means that the Edge or agreement corporation, any parent insured bank, and the bank holding company either received a composite rating of 1 or 2 or is considered satisfactory under the applicable rating system, and has at least a satisfactory rating for management if such a rating is given, at their most recent examination or review.

- 3. Section 211.9 is amended by revising paragraph (a) to read as follows:

**§ 211.9 Investment Procedures.**

\* \* \* \* \*

(a) \* \* \*

(2) *Composite rating.* Except as the Board may otherwise determine, in order for an investor to make investments under the general consent or limited general consent procedures of paragraphs (b) and (c) of this section, at the most recent examination the investor and any parent insured bank must have either received a composite rating of at least 2 or be considered satisfactory under the applicable rating system.

**PART 238—SAVINGS AND LOAN HOLDING COMPANIES (REGULATION LL)**

- 1. The authority citations for part 211 continues to read as follows: Authority: 5 U.S.C. 552, 559; 12 U.S.C. 1462, 1462a, 1463, 1464, 1467, 1467a, 1468, 1813, 1817, 1829e, 1831i, 1972; 15 U.S.C. 78l.
- 2. Section 238.54 is amended by revising paragraph (a) to read as follows:

**§ 238.54 Permissible bank holding company activities of savings and loan holding companies.**

\* \* \* \* \*

(a)(1) The holding company received a rating of satisfactory or above prior to January 1, 2008, or thereafter, either received a composite rating of “1” or “2” or be considered satisfactory under the applicable rating system in its most recent examination, and is not in a troubled condition as defined in § 238.72, and the holding company does not propose to commence the activity by an acquisition (in whole or in part) of a going concern; or

## IX. Text of Large Financial Institution Rating System

### A. Overview

Each large financial institution (LFI) is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations), including its critical operations and banking offices, remain safe and sound and in compliance with laws and regulations, including those related to consumer protection.<sup>31</sup> The LFI rating system provides a supervisory evaluation of whether a covered firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.<sup>32</sup> The LFI rating system applies to bank holding companies with total consolidated assets of \$100 billion or more; all non-insurance, non-commercial savings and loan holding companies with total consolidated assets of \$100 billion or more; and U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of \$50 billion or more established pursuant to the Federal Reserve’s Regulation YY.<sup>33</sup>

The LFI rating system is designed to:

- Fully align with the Federal Reserve’s current supervisory programs and practices, which are based upon the LFI supervision framework’s core objectives of reducing the probability of LFIs failing or experiencing material distress and reducing the risk to U.S. financial stability;

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<sup>31</sup> See SR letter 12-17/CA letter 12-14, “Consolidated Supervisory Framework for Large Financial Institutions,” at <http://www.federalreserve.gov/bankinfo/srletters/sr1217.htm>.

Hereinafter, when “safe and sound” or “safety and soundness” is used in this framework, related expectations apply to the consolidated organization and the firm’s critical operations and banking offices.

“Critical operations” are a firm’s operations, including associated services, functions and support, the failure or discontinuance of which, in the view of the firm or the Federal Reserve, would pose a threat to the financial stability of the United States.

“Banking offices” are defined as U.S. depository institution subsidiaries, as well as the U.S. branches and agencies of foreign banking organizations.

<sup>32</sup> “Financial strength and resilience” is defined as maintaining effective capital and liquidity governance and planning processes, and sufficiency of related positions, to provide for the continuity of the consolidated organization (including its critical operations and banking offices) through a range of conditions.

“Operational strength and resilience” is defined as maintaining effective governance and controls to provide for the continuity of the consolidated organization (including its critical operations and banking offices) and to promote compliance with laws and regulations, including those related to consumer protection, through a range of conditions.

References to “financial or operational” weaknesses or deficiencies implicate a firm’s financial or operational strength and resilience.

<sup>33</sup> Total consolidated assets will be calculated based on the average of the firm’s total consolidated assets in the four most recent quarters as reported on the firm’s quarterly financial reports filed with the Federal Reserve. A firm will continue to be rated under the LFI rating system until it has less than \$95 billion in total consolidated assets, based on the average total consolidated assets as reported on the firm’s four most recent quarterly financial reports filed with the Federal Reserve. As noted in the proposal, the Federal Reserve may determine to apply the RFI rating system or another applicable rating system in certain limited circumstances.

- Enhance the clarity and consistency of supervisory assessments and communications of supervisory findings and implications; and
- Provide transparency related to the supervisory consequences of a given rating.

The LFI rating system is comprised of three components:

- *Capital Planning and Positions*: an evaluation of (i) the effectiveness of a firm’s governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions and events; and (ii) the sufficiency of a firm’s capital positions to comply with applicable regulatory requirements and to support the firm’s ability to continue to serve as a financial intermediary through a range of conditions.
- *Liquidity Risk Management and Positions*: an evaluation of (i) the effectiveness of a firm’s governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (ii) the sufficiency of a firm’s liquidity positions to comply with applicable regulatory requirements and to support the firm’s ongoing obligations through a range of conditions.
- *Governance and Controls*: an evaluation of the effectiveness of a firm’s (i) board of directors,<sup>34</sup> (ii) management of business lines and independent risk management and controls,<sup>35</sup> and (iii) recovery planning (only for domestic firms that are subject to the Board’s Large Institution Supervision Coordinating Committee (LISCC) Framework).<sup>36</sup> This rating assesses a firm’s effectiveness in aligning strategic business objectives with the firm’s risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise planning for the ongoing resiliency of the firm.<sup>37</sup>

## **B. Assignment of the LFI Component Ratings**

Each LFI component rating is assigned along a four-level scale:

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<sup>34</sup> References to “board” or “board of directors” in this framework includes the equivalent to a board of directors, as appropriate, as well as committees of the board of directors or the equivalent thereof, as appropriate.

At this time, recovery planning expectations only apply to domestic bank holding companies subject to the Federal Reserve’s LISCC supervisory framework. Should the Federal Reserve expand the scope of recovery planning expectations to encompass additional firms, this rating will reflect such expectations for the broader set of firms.

<sup>35</sup> The evaluation of the effectiveness of management of business lines would include management of critical operations.

<sup>36</sup> There are eight domestic firms in the LISCC portfolio: (1) Bank of America Corporation; (2) Bank of New York Mellon Corporation; (3) Citigroup, Inc.; (4) Goldman Sachs Group, Inc.; (5) JP Morgan Chase & Co.; (6) Morgan Stanley; (7) State Street Corporation; and (8) Wells Fargo & Company. In this guidance, these eight firms may collectively be referred to as “domestic LISCC firms.”

<sup>37</sup> “Risk appetite” is defined as the aggregate level and types of risk the board and senior management are willing to assume to achieve the firm’s strategic business objectives, consistent with applicable capital, liquidity, and other requirements and constraints.

- *Broadly Meets Expectations*: A firm’s practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions. The firm may be subject to identified supervisory issues requiring corrective action. These issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of conditions.
- *Conditionally Meets Expectations*: Certain, material financial or operational weaknesses in a firm’s practices or capabilities may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

The Federal Reserve does not intend for a firm to be assigned a “Conditionally Meets Expectations” rating for a prolonged period, and will work with the firm to develop an appropriate timeframe to fully resolve the issues leading to the rating assignment and merit upgrade to a “Broadly Meets Expectations” rating.

A firm is assigned a “Conditionally Meets Expectations” rating – as opposed to a “Deficient” rating – when it has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices. Failure to resolve the issues in a timely manner would most likely result in the firm’s downgrade to a “Deficient” rating, since the inability to resolve the issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is recognized that completion and validation of remediation activities for select supervisory issues – such as those involving information technology modifications – may require an extended time horizon. In all instances, appropriate and effective risk mitigation techniques must be utilized in the interim to maintain safe-and-sound operations under a range of conditions until remediation activities are completed, validated, and fully operational.

- *Deficient-1*: Financial or operational deficiencies in a firm’s practices or capabilities put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require the firm to make a material change to its business model or financial profile, or its practices or capabilities.

A firm’s failure to resolve the issues in a timely manner that gave rise to a “Conditionally Meets Expectations” rating would most likely result in its downgrade to a “Deficient” rating.

A firm with a “Deficient-1” rating is required to take timely corrective action to correct financial or operational deficiencies and to restore and maintain its safety and soundness and compliance with laws and regulations, including those related to consumer protection. There is a strong presumption that a firm with a “Deficient-1” rating will be subject to an informal or formal enforcement action, and this rating assignment could be a barrier for a firm seeking Federal Reserve approval to engage in new or expansionary activities.

- *Deficient-2*: Financial or operational deficiencies in a firm’s practices or capabilities present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition.

A firm with a “Deficient-2” rating is required to immediately implement comprehensive corrective measures, and demonstrate the sufficiency of contingency planning in the event of further deterioration. There is a strong presumption that a firm with a “Deficient-2” rating will be subject to a formal enforcement action, and the Federal Reserve would be unlikely to approve any proposal from a firm with this rating to engage in new or expansionary activities.

The Federal Reserve will take into account a number of individual elements of a firm’s practices, capabilities and performance when making each component rating assignment. The weighting of an individual element in assigning a component rating will depend on its impact on the firm’s safety, soundness and resilience as provided for in the LFI rating system definitions. For example, for purposes of the Governance and Controls rating, a limited number of significant deficiencies – or even just one significant deficiency – noted for management of a single material business line could be viewed as sufficiently important to warrant a “Deficient-1” for the Governance and Controls component rating, even if the firm meets supervisory expectations under the Governance and Controls component in all other respects.

Under the LFI rating system, a firm must be rated “Broadly Meets Expectations” or “Conditionally Meets Expectations” for each of the three component ratings (Capital, Liquidity, Governance and Controls) to be considered “well managed” in accordance with various statutes and regulations.<sup>38</sup> A “well managed” firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones.

### **C. LFI Rating Components**

The LFI rating system is comprised of three component ratings:<sup>39</sup>

#### **1. Capital Planning and Positions Component Rating**

The Capital Planning and Positions component rating evaluates (i) the effectiveness of a firm’s governance and planning processes used to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions; and (ii) the sufficiency of a firm’s capital positions to comply with applicable regulatory requirements and to support the firm’s ability to continue to serve as a financial intermediary through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Capital Planning*: The extent to which a firm maintains sound capital planning practices through effective governance and oversight; effective risk management and controls;

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<sup>38</sup> 12 U.S.C. § 1841 et. seq. and 12 U.S.C. § 1461 et seq. See, e.g., 12 CFR 225.4(b)(6), 225.14, 225.22(a), 225.23, 225.85, and 225.86; 12 CFR 211.9(b), 211.10(a)(14), and 211.34; and 12 CFR 223.41.

<sup>39</sup> There may be instances where deficiencies or supervisory issues may be relevant to the Federal Reserve’s assessment of more than one component area. As such, the LFI rating will reflect these deficiencies or issues within multiple rating components when necessary to provide a comprehensive supervisory assessment.



maintenance of updated capital policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into capital planning and projections of capital positions; and

- *Capital Positions*: The extent to which a firm’s capital is sufficient to comply with regulatory requirements, and to support its ability to meet its obligations to depositors, creditors, and other counterparties and continue to serve as a financial intermediary through a range of conditions.

### ***Definitions for the Capital Planning and Positions Component Rating***

#### ***Broadly Meets Expectations***

A firm’s capital planning and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of capital adequacy through a range of conditions; and
- The firm’s current and projected capital positions comply with regulatory requirements, and support its ability to absorb current and potential losses, to meet obligations, and to continue to serve as a financial intermediary through a range of conditions.

A firm rated “Broadly Meets Expectations” may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the capital planning and position expectations associated with a “Broadly Meets Expectations” rating will be rated “Conditionally Meets Expectations,” “Deficient-1,” or “Deficient-2,” and subject to potential consequences as outlined below.

#### ***Conditionally Meets Expectations***

Certain, material financial or operational weaknesses in a firm’s capital planning or positions may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm’s ability to produce sound assessments of capital adequacy through a range of conditions; and/or
- May result in the firm’s projected capital positions being insufficient to absorb potential losses, comply with regulatory requirements, and support the firm’s ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated “Conditionally Meets Expectations” for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management, or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm

would be required to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating.

The Federal Reserve will closely monitor the firm’s remediation and mitigation activities; in most instances, the firm will either:

- (i) Resolve the issues in a timely manner and, if no new material supervisory issues arise, be upgraded to a “Broadly Meets Expectations” rating because the firm’s capital planning practices and related positions would broadly meet supervisory expectations; or
- (ii) Fail to resolve the issues in a timely manner and be downgraded to a “Deficient-1” rating, because the inability to resolve the issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues are identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

A “Conditionally Meets Expectations” rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated “Deficient-1” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that the firm’s prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

#### *Deficient-1*

Financial or operational deficiencies in a firm’s capital planning or positions put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm’s business model or financial profile, or its capital planning practices.

Specifically, although the firm’s current condition is not considered to be materially threatened:

- Deficiencies in the firm’s capital planning processes are not effectively mitigated. These deficiencies limit the firm’s ability to effectively assess capital adequacy through a range of conditions; and/or
- The firm’s projected capital positions may be insufficient to absorb potential losses and to support its ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm’s safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business – such as issues requiring a material change to the firm’s business model or financial profile, or its

governance, risk management or internal control structures or practices – would generally warrant assignment of a “Deficient-1” rating.

A “Deficient-1” rating may be assigned to a firm regardless of its prior rating. A firm previously rated “Broadly Meets Expectations” may be downgraded to “Deficient-1” when supervisory issues are identified that place the firm’s prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated “Conditionally Meets Expectations” may be downgraded to “Deficient-1” when the firm’s inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its capital planning and positions consistent with supervisory expectations. There is a strong presumption that a firm rated “Deficient-1” will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated “Deficient-1” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. A “Deficient-1” rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the firm from remediating current deficiencies or issues.

#### *Deficient-2*

Financial or operational deficiencies in a firm’s capital planning or positions present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm’s capital planning processes are insufficient to effectively assess the firm’s capital adequacy through a range of conditions; and/or
- The firm’s current or projected capital positions are insufficient to absorb current or potential losses, and to support the firm’s ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (i) implement comprehensive corrective measures sufficient to restore and maintain appropriate capital planning capabilities and adequate capital positions; and (ii) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. There is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve.

A firm rated “Deficient-2” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated “Deficient-2” to engage in new or expansionary activities.

## 2. Liquidity Risk Management and Positions Component Rating

The Liquidity Risk Management and Positions component rating evaluates (i) the effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and (ii) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

In developing this rating, the Federal Reserve evaluates:

- *Liquidity Risk Management*: The extent to which a firm maintains sound liquidity risk management practices through effective governance and oversight; effective risk management and controls; maintenance of updated liquidity policies and contingency plans for addressing potential shortfalls; and incorporation of appropriately stressful conditions into liquidity planning and projections of liquidity positions; and
- *Liquidity Positions*: The extent to which a firm's liquidity is sufficient to comply with regulatory requirements, and to support its ability to meet current and prospective obligations to depositors, creditors and other counterparties through a range of conditions.

### *Definitions for the Liquidity Risk Management and Positions Component Rating*

#### *Broadly Meets Expectations*

A firm's liquidity risk management and positions broadly meet supervisory expectations and support maintenance of safe-and-sound operations. Specifically:

- The firm is capable of producing sound assessments of liquidity adequacy through a range of conditions; and
- The firm's current and projected liquidity positions comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

A firm rated "Broadly Meets Expectations" may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm's ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet the liquidity risk management and position expectations associated with a "Broadly Meets Expectations" rating will be rated "Conditionally Meets Expectations," "Deficient-1," or "Deficient-2," and subject to potential consequences as outlined below.

#### *Conditionally Meets Expectations*

Certain, material financial or operational weaknesses in a firm's liquidity risk management or positions may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses:

- May threaten the firm’s ability to produce sound assessments of liquidity adequacy through a range of conditions; and/or
- May result in the firm’s projected liquidity positions being insufficient to comply with regulatory requirements, and support its ability to meet current and prospective obligations and to continue to serve as a financial intermediary through a range of conditions.

The Federal Reserve does not intend for a firm to be rated “Conditionally Meets Expectations” for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating.

The Federal Reserve will closely monitor the firm’s remediation and mitigation activities; in most instances, the firm will either:

- (i) Resolve the issues in a timely manner and, if no new material supervisory issues arise, and be upgraded to a “Broadly Meets Expectations” rating because the firm’s liquidity risk management practices and related positions would broadly meet supervisory expectations; or
- (ii) Fail to resolve the issues in a timely manner and be downgraded to a “Deficient-1” rating, because the firm’s inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues are identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

A “Conditionally Meets Expectations” rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated “Deficient-1” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that the firm’s prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

#### *Deficient-1*

Financial or operational deficiencies in a firm’s liquidity risk management or positions put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm’s business model or financial profile, or its liquidity risk management practices.

Specifically, although the firm's current condition is not considered to be materially threatened:

- Deficiencies in the firm's liquidity risk management processes are not effectively mitigated. These deficiencies limit the firm's ability to effectively assess liquidity adequacy through a range of conditions; and/or
- The firm's projected liquidity positions may be insufficient to support its ability to meet prospective obligations and serve as a financial intermediary through a range of conditions.

Supervisory issues that place the firm's safety and soundness at significant risk, and where resolution is likely to require steps that clearly go beyond the normal course of business – such as issues requiring a material change to the firm's business model or financial profile, or its governance, risk management or internal control structures or practices – would generally warrant assignment of a "Deficient-1" rating.

A "Deficient-1" rating may be assigned to a firm regardless of its prior rating. A firm previously rated "Broadly Meets Expectations" may be downgraded to "Deficient-1" when supervisory issues are identified that place the firm's prospects for maintaining safe-and-sound operations through a range of potentially stressful conditions at significant risk. A firm previously rated "Conditionally Meets Expectations" may be downgraded to "Deficient-1" when the firm's inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its liquidity risk management and positions consistent with supervisory expectations. There is a strong presumption that a firm rated "Deficient-1" will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated "Deficient-1" for any rating component would not be considered "well managed," which would subject the firm to various consequences. A "Deficient-1" rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the firm from remediating current deficiencies or issues.

#### *Deficient-2*

Financial or operational deficiencies in a firm's liquidity risk management or positions present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

Specifically, as a result of these deficiencies:

- The firm's liquidity risk management processes are insufficient to effectively assess the firm's liquidity adequacy through a range of conditions; and/or

- The firm’s current or projected liquidity positions are insufficient to support the firm’s ability to meet current and prospective obligations and serve as a financial intermediary through a range of conditions.

To address these deficiencies, the firm is required to immediately (i) implement comprehensive corrective measures sufficient to restore and maintain appropriate liquidity risk management capabilities and adequate liquidity positions; and (ii) demonstrate the sufficiency, credibility and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. There is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve.

A firm rated “Deficient-2” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated “Deficient-2” to engage in new or expansionary activities.

### **3. Governance and Controls Component Rating**

The Governance and Controls component rating evaluates the effectiveness of a firm’s (i) board of directors, (ii) management of business lines and independent risk management and controls, and (iii) recovery planning (for domestic LISCC firms only). This rating assesses a firm’s effectiveness in aligning strategic business objectives with the firm’s risk appetite and risk management capabilities; maintaining effective and independent risk management and control functions, including internal audit; promoting compliance with laws and regulations, including those related to consumer protection; and otherwise providing for the ongoing resiliency of the firm.

In developing this rating, the Federal Reserve evaluates:

- *Effectiveness of the Board of Directors:* The extent to which the board exhibits attributes that are consistent with those of effective boards in carrying out its core roles and responsibilities, including: (i) setting a clear, aligned, and consistent direction regarding the firm’s strategy and risk appetite; (ii) directing senior management regarding the board’s information; (iii) overseeing and holding senior management accountable, (iv) supporting the independence and stature of independent risk management and internal audit; and (v) maintaining a capable board composition and governance structure.
- *Management of Business Lines and Independent Risk Management and Controls*

The extent to which:

- Senior management effectively and prudently manages the day-to-day operations of the firm and provides for ongoing resiliency; implements the firm’s strategy and risk appetite; maintains an effective risk management framework and system of internal controls; and promotes prudent risk taking behaviors and business practices, including compliance with laws and regulations, including those related to consumer protection.
- Business line management executes business line activities consistent with the firm’s strategy and risk appetite; identifies and manages risks; and ensures an effective system of internal controls for its operations.

- Independent risk management effectively evaluates whether the firm’s risk appetite appropriately captures material risks and is consistent with the firm’s risk management capacity; establishes and monitors risk limits that are consistent with the firm’s risk appetite; identifies and measures the firm’s risks; and aggregates, assesses and reports on the firm’s risk profile and positions. Additionally, the firm demonstrates that its internal controls are appropriate and tested for effectiveness. Finally, internal audit effectively and independently assesses the firm’s risk management framework and internal control systems, and reports findings to senior management and the firm’s audit committee.
- *Recovery Planning (domestic LISC firms only)*: The extent to which recovery planning processes effectively identify options that provide a reasonable chance of a firm being able to remedy financial weakness and restore market confidence without extraordinary official sector support.

### ***Definitions for the Governance and Controls Component Rating***

#### ***Broadly Meets Expectations***

A firm’s governance and controls broadly meet supervisory expectations and support maintenance of safe-and-sound operations.

Specifically, the firm’s practices and capabilities are sufficient to align strategic business objectives with its risk appetite and risk management capabilities,<sup>40</sup> maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); and otherwise provide for the firm’s ongoing financial and operational resiliency through a range of conditions.

A firm rated “Broadly Meets Expectations” may be subject to identified supervisory issues requiring corrective action. However, these issues are unlikely to present a threat to the firm’s ability to maintain safe-and-sound operations through a range of potentially stressful conditions.

A firm that does not meet supervisory expectations associated with a “Broadly Meets Expectations” rating will be rated “Conditionally Meets Expectations,” “Deficient-1,” or “Deficient-2,” and subject to potential consequences, as outlined below.

#### ***Conditionally Meets Expectations***

Certain, material financial or operational weaknesses in a firm’s governance and controls practices may place the firm’s prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

Specifically, if left unresolved, these weaknesses may threaten the firm’s ability to align strategic business objectives with the firm’s risk appetite and risk management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm’s ongoing resiliency through a range of conditions.

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<sup>40</sup> References to risk management capabilities includes risk management of business lines and independent risk management and control functions, including internal audit.



The Federal Reserve does not intend for a firm to be rated “Conditionally Meets Expectations” for a prolonged period. The firm has the ability to resolve these issues through measures that do not require a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices. The Federal Reserve will work with the firm to develop an appropriate timeframe during which the firm would be required to resolve each supervisory issue leading to the “Conditionally Meets Expectations” rating.

The Federal Reserve will closely monitor the firm’s remediation and mitigation activities; in most instances, the firm will either:

- (i) Resolve the issues in a timely manner and, if no new material supervisory issues arise, and be upgraded to a “Broadly Meets Expectations” rating because the firm’s governance and controls would broadly meet supervisory expectations; or
- (ii) Fail to resolve the issues in a timely manner and be downgraded to a “Deficient-1” rating, because the firm’s inability to resolve those issues would indicate that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

It is possible that a firm may be close to completing resolution of the supervisory issues leading to the “Conditionally Meets Expectations” rating, but new issues are identified that, taken alone, would be consistent with a “Conditionally Meets Expectations” rating. In this event, the firm may continue to be rated “Conditionally Meets Expectations,” provided the new issues do not reflect a pattern of deeper or prolonged capital planning or position weaknesses consistent with a “Deficient” rating.

A “Conditionally Meets Expectations” rating may be assigned to a firm that meets the above definition regardless of its prior rating. A firm previously rated “Deficient” may be upgraded to “Conditionally Meets Expectations” if the firm’s remediation and mitigation activities are sufficiently advanced so that the firm’s prospects for remaining safe and sound are no longer at significant risk, even if the firm has outstanding supervisory issues or is subject to an active enforcement action.

#### *Deficient-1*

Financial or operational deficiencies in a firm’s governance and controls put the firm’s prospects for remaining safe and sound through a range of conditions at significant risk. The firm is unable to remediate these deficiencies in the normal course of business, and remediation would typically require a material change to the firm’s business model or financial profile, or its governance, risk management or internal control structures or practices.

Specifically, although the firm’s current condition is not considered to be materially threatened, these deficiencies limit the firm’s ability to align strategic business objectives with its risk appetite and risk management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm’s ongoing resiliency through a range of conditions.

A “Deficient-1” rating may be assigned to a firm regardless of its prior rating. A firm previously rated “Broadly Meets Expectations” may be downgraded to “Deficient-1” when supervisory issues are identified that place the firm’s prospects for maintaining safe-and-sound

operations through a range of potentially stressful conditions at significant risk. A firm previously rated “Conditionally Meets Expectations” may be downgraded to “Deficient-1” when the firm’s inability to resolve supervisory issues in a timely manner indicates that the firm does not possess sufficient financial or operational capabilities to maintain its safety and soundness through a range of conditions.

To address these financial or operational deficiencies, the firm is required to take timely corrective action to restore and maintain its governance and controls consistent with supervisory expectations. There is a strong presumption that a firm rated “Deficient-1” will be subject to an informal or formal enforcement action by the Federal Reserve.

A firm rated “Deficient-1” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. A “Deficient-1” rating could be a barrier for a firm seeking Federal Reserve approval of a proposal to engage in new or expansionary activities, unless the firm can demonstrate that (i) it is making meaningful, sustained progress in resolving identified deficiencies and issues; (ii) the proposed new or expansionary activities would not present a risk of exacerbating current deficiencies or issues or lead to new concerns; and (iii) the proposed activities would not distract the firm from remediating current deficiencies or issues.

#### *Deficient-2*

Financial or operational deficiencies in governance or controls present a threat to the firm’s safety and soundness, or have already put the firm in an unsafe and unsound condition. Specifically, as a result of these deficiencies, the firm is unable to align strategic business objectives with its risk appetite and risk management capabilities; maintain effective and independent risk management and control functions, including internal audit; promote compliance with laws and regulations (including those related to consumer protection); or otherwise provide for the firm’s ongoing resiliency.

To address these deficiencies, the firm is required to immediately (i) implement comprehensive corrective measures sufficient to restore and maintain appropriate governance and control capabilities; and (ii) demonstrate the sufficiency, credibility, and readiness of contingency planning in the event of further deterioration of the firm’s financial or operational strength or resiliency. There is a strong presumption that a firm rated “Deficient-2” will be subject to a formal enforcement action by the Federal Reserve.

A firm rated “Deficient-2” for any rating component would not be considered “well managed,” which would subject the firm to various consequences. The Federal Reserve would be unlikely to approve any proposal from a firm rated “Deficient-2” to engage in new or expansionary activities.

By order of the Board of Governors of the Federal Reserve System, November 2, 2018.

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Ann Misback,  
*Secretary of the Board.*