Report to Congress on Implementation of Enhanced Prudential Standards

January 2018

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) requires the Board of Governors of the Federal Reserve System (Board) to establish enhanced prudential standards for bank holding companies and foreign banking organizations with total consolidated assets of $50 billion or more and nonbank financial companies that have been designated by the Financial Stability Oversight Council (the Council) for supervision by the Board. The standards must include enhanced risk-based and leverage capital, liquidity, risk management and risk committee requirements; a requirement to submit a resolution plan; single-counterparty credit limits; stress test requirements; and, for companies that the Council has determined pose a grave threat to financial stability, a debt-to-equity limit. Section 165 also permits the Board to establish additional prudential standards, including three enumerated standards—a contingent capital requirement, enhanced public disclosures, and short-term debt limits—and other prudential standards that the Board determines are appropriate.

The Board has developed an integrated set of prudential standards for the companies covered under section 165 through a series of rulemakings, including a capital plan rule, stress testing rules, a resolution plan rule, a liquidity coverage ratio rule, restrictions on qualified financial contracts, and an enhanced prudential standards rule under Regulation YY. In addition, for the largest, most complex bank holding companies, the Board has adopted a risk-based capital surcharge for firms identified as global systemically important U.S. bank holding companies, requirements relating to maintaining a minimum amount of both long-term unsecured debt and total loss-absorbing capacity, and enhanced leverage capital requirements through a supplementary leverage ratio and an enhanced supplementary leverage ratio. As discussed further below, the Board is continuing development of prudential standards through future rulemakings and orders, including a net stable funding ratio and single-counterparty credit limits.

The integrated set of standards will increase the resiliency of companies covered under section 165 and should mitigate the risk that the failure or material financial distress of these firms could pose to U.S. financial stability. The Board regularly reviews its regulations, including those implementing section 165, to ensure that they promote safety and soundness, foster economic growth and business opportunity, and reflect coordination with other federal agencies.

Implementation of Enhanced Prudential Standards since Prior Report

Risk-Based Capital Surcharge for Global Systemically Important Bank Holding Companies

In July 2015, the Board adopted a final rule requiring the largest, most systemically important U.S. bank holding companies to further strengthen their capital positions.[1] Under the rule, a firm that is identified as a global systemically important bank holding company (GSIB) must hold additional capital to increase its resiliency in light of the greater threat it poses to the financial stability of the United States or face limits on capital distributions, such as dividend payments, and discretionary bonus payments to senior executives.

The final rule establishes the criteria for identifying a GSIB and the methods that those firms use to calculate a risk-based capital surcharge, which is calibrated to each firm's overall systemic risk. The final rule requires GSIBs to calculate their surcharges

1 See 12 CFR part 217, subpart H.

under two methods and use the higher of the two surcharges. The first method is based on the framework agreed to by the Basel Committee on Banking Supervision and considers a GSIB's size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity. The second method uses similar inputs but is calibrated to result in significantly higher surcharges and replaces substitutability with a measure of the firm's reliance on short-term wholesale funding. In addition to issuing a final rule, the Board released a white paper in July 2015 describing how GSIB surcharges are calibrated.

Long-term Debt and Total Loss-Absorbing Capacity Requirement

In December 2016, the Board adopted a final rule to strengthen the resolvability of the largest domestic and foreign banks operating in the United States without any support from taxpayer-provided capital.[2]

The final rule requires the parent holding companies of U.S. global systemically important banking organizations and the top-tier U.S. intermediate holding companies of foreign global systemically important banking organizations (collectively known as covered companies) to maintain outstanding a minimum amount of long-term unsecured debt, as well as a minimum amount of total loss-absorbing capacity and related buffers. Requiring a U.S. global systemically important banking organization to maintain sufficient amounts of long-term debt, which can be converted to equity during resolution, would strengthen resolvability by providing a source of private capital to support the firm's critical operations during resolution. The final rule also applies limitations at the top-tier holding company level that will prohibit or limit covered companies from entering into certain financial arrangements that could impair their resolvability and the resiliency of their operating subsidiaries.

Liquidity Coverage Ratio Rule Disclosures

In December 2016, the Board adopted a final rule that amends the liquidity coverage ratio (LCR) rule to implement public disclosure requirements for certain companies subject to the LCR rule.[3] The final rule applies to bank holding companies and certain savings and loan holding companies with total consolidated assets of $50 billion or more or total on-balance sheet foreign exposure of $10 billion or more. These companies are required to disclose information about certain components of their LCR calculations on a quarterly average basis in a standardized format and to discuss certain features of their LCR results. In addition, the Board simultaneously amended the modified LCR rule to provide one full year for bank holding companies and certain savings and loan holding companies to come into compliance with the LCR public disclosure rule.

Capital Planning and Stress Testing

In January 2017, the Board adopted a final rule amending its capital plan[4] and stress testing rules;[5] the changes took effect for purposes of the 2017 Comprehensive Capital Analysis and Review (CCAR) cycle. The final rule removed large and noncomplex firms from the qualitative assessment and qualitative objection criteria in the Board's capital plan rule in order to reduce burden on these firms and focus the qualitative review in CCAR on the largest and most complex financial institutions.

Through CCAR, the Federal Reserve evaluates the capital planning processes and capital adequacy of large financial institutions through quantitative and qualitative assessments.[6] The qualitative assessment evaluates the strength of each firm's capital planning process, whereas the quantitative assessment evaluates each firm's capital adequacy based on hypothetical scenarios of severe economic and financial market stress. Under the previous capital plan rule, the Board could object to the annual capital plan of any CCAR firm based on the quantitative or qualitative findings of the CCAR exercise.

2 See 12 CFR part 252, subparts G & P.

3 See 12 CFR part 249.

4 12 CFR 225.8.

5 See 12 CFR part 252.

6 Large institutions subject to the Board's capital plan and stress testing rules include: (i) bank holding companies with total consolidated assets of $50 billion or more; (ii) any nonbank financial company supervised by the Board that becomes subject to the capital planning and stress test requirements pursuant to a rule or order of the Board; and (iii) U.S. intermediate holding companies of foreign banking organizations in accordance with the transition provisions under the capital plan rule and subpart O of the Board's Regulation YY (12 CFR part 252). Currently, no nonbank financial companies supervised by the Board are subject to the capital planning or stress test requirements. A U.S. intermediate holding company that was required to be established by July 1, 2016, and that was not previously subject to the Board's capital plan rule was required to submit its first capital plan in 2017 and will become subject to the Board's stress test rules beginning in 2018.

Under the final rule, a large and noncomplex firm is defined as a financial institution (i) with total consolidated assets between $50 billion and $250 billion; (ii) with total consolidated nonbank assets of less than $75 billion; and (iii) that has not been identified as a global systemically important bank under the Board's capital rules. Large and noncomplex firms will be required to continue meeting capital requirements under stress as part of CCAR's quantitative assessment, and the Federal Reserve will examine the capital planning processes of large and noncomplex firms through regular supervisory assessments outside of the CCAR exercise. Under the final rule, the Board may object to the capital plans of large and noncomplex firms on quantitative grounds, and may object to the capital plans of the largest and most complex firms on both qualitative and quantitative grounds.

Resolution Planning

In April 2016, the Board and Federal Deposit Insurance Corporation (FDIC) jointly announced determinations and provided firm-specific feedback on the 2015 resolution plans of eight systemically important, domestic banking institutions.[7]

The agencies jointly determined that the 2015 resolution plans of Bank of America, Bank of New York Mellon, JP Morgan Chase, State Street, and Wells Fargo were not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code, which is the statutory standard established in the Dodd-Frank Act. The agencies issued joint notices of deficiencies to these five firms detailing the deficiencies in their plans and the actions the firms must take to address them. These firms submitted revised plans in October 2016. In December 2016, the Board and the FDIC announced that the firms, other than Wells Fargo, had adequately remediated the identified deficiencies. Wells Fargo did not adequately remedy all of its deficiencies and was subject to restrictions on certain activities until the deficiencies were remedied. Wells Fargo filed a revised submission in March 2017 that the Board and FDIC determined adequately remediated its remaining deficiencies.

The Board and the FDIC also jointly identified weaknesses in the 2015 resolution plans of Goldman Sachs and Morgan Stanley that the firms must address, but the agencies did not make joint determinations regarding the plans and their deficiencies. The FDIC determined that the plan submitted by Goldman Sachs was not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code, and identified deficiencies. The Board identified a deficiency in Morgan Stanley's plan and found that the plan was not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code.

Neither the Board nor the FDIC found that Citigroup's 2015 resolution plan was not credible or would not facilitate an orderly resolution under the U.S. Bankruptcy Code, although the agencies did identify shortcomings that the firm must address. The agencies also issued guidance to help all eight domestic, systemically important financial institutions improve their next resolution plans. The deadline for the next full plan submission was July 1, 2017, and all eight firms submitted their plans by the deadline.

Intermediate Holding Company Requirement for Foreign Banking Organizations

In July 2016 and 2017, an intermediate holding company (IHC) requirement under Regulation YY was phased in for foreign banking organizations (FBOs).[8] Among other requirements for FBOs, Regulation YY requires an FBO with $50 billion or more in total U.S. non-branch assets to establish an IHC and transfer its ownership interest in its U.S. subsidiaries to the IHC. An FBO that exceeded the $50 billion threshold as of July 1, 2015, was required to hold its ownership interests in any bank holding company, any depository institution, and its U.S. subsidiaries representing 90 percent of the FBO's assets not held under a bank holding company under the IHC by July 1, 2016, and its ownership interests in any remaining U.S. subsidiaries under the IHC by July 1, 2017.[9] The principal purpose of the IHC requirement is to enhance the resiliency of the U.S. operations of an FBO, and as a result, U.S. financial stability.

7 See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160413a.htm; see also 12 CFR part 243.

8 See 12 CFR part 252.

9 12 CFR 252.152(c).

Restrictions on Qualified Financial Contracts

In September 2017, the Board issued a final rule to support U.S. financial stability by enhancing the resolvability of very large and complex financial firms.[10] The rule requires GSIBs and the U.S. operations of foreign GSIBs (collectively, covered entities) to amend their derivative, securities financing, and other qualified financial contracts (QFCs) to prevent the disorderly unwind of the contracts if the parent or another entity within the firm enters bankruptcy or a resolution process. Given the large volume of QFCs to which these entities are a party, the exercise of default rights en masse as a result of the failure of one of the firms could lead to a disorderly resolution.

The final rule requires covered entities to make clear in their QFCs that both of the U.S. resolution regimes for financial companies and institutions (i.e., Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act) apply to the contracts. This requirement should reduce the risk of a foreign court disregarding provisions of Title II of the Dodd-Frank Act and the Federal Deposit Insurance Act that temporarily stay the termination of QFCs. The rule also requires covered entities to ensure that their QFCs restrict the ability of their counterparties to terminate the contract, liquidate collateral, or exercise other default rights based on the resolution or liquidation of an affiliate of the GSIB in bankruptcy or in a resolution. The rule identifies protocols, including the International Swaps and Derivatives Association 2015 Universal Resolution Stay Protocol, that comply with the rule. The final rule also makes technical, conforming amendments to the Board's capital and liquidity rules.

Continued Development of Enhanced Prudential Standards

The Board continues to develop additional enhanced prudential standards for large banking organizations. These standards are designed to complement the standards discussed above and to further mitigate the risks to the financial stability of the United States presented by large banking organizations.

[10] 82 FR 42882 (September 12, 2017).

Single-Counterparty Credit Limits

In March 2016, the Board proposed a rule that would apply single-counterparty credit limits to bank holding companies with total consolidated assets of $50 billion or more for public comment, as required by section 165(e) of the Dodd-Frank Act.[11] The proposed rule addresses the risk associated with excessive credit exposures of large banking organizations to a single counterparty and includes limits that are tailored to increase in stringency as the systemic footprint of a bank holding company increases. The proposed rule also includes similarly-tailored requirements for foreign banks operating in the United States.

Net Stable Funding Ratio

In May 2016, the Board, the Office of the Comptroller of the Currency, and the FDIC jointly proposed a rule that would implement the net stable funding ratio (NSFR), a stable funding requirement for large and internationally active banking organizations.[12] The NSFR is designed to reduce the likelihood that disruptions to a firm's regular sources of funding will compromise its liquidity position over a one-year time horizon. The NSFR would be the second quantitative liquidity requirement for U.S. banking firms.

The proposed rule, which would complement the liquidity coverage ratio, would require covered companies to maintain a minimum level of stable funding based on the liquidity characteristics of the covered company's assets, funding commitments, and derivative exposures over a one-year time horizon. The most stringent NSFR requirements would apply to banking organizations with total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposure of $10 billion or more, and their subsidiary insured depository institutions with $10 billion or more of total consolidated assets. The proposed rule would apply a less stringent NSFR requirement to certain smaller depository institution holding companies with $50 billion or more in total consolidated assets that are not otherwise covered by the rule.

[11] 81 FR 14327 (March 16, 2017).

[12] 81 FR 35123 (June 1, 2016).

Capital Standards for Supervised Institutions Significantly Engaged in Insurance Activities

In June 2016, the Board sought comment on an advance notice of proposed rulemaking (ANPR) regarding conceptual frameworks for capital standards that could apply to certain nonbank financial companies with significant insurance activities that the Council has determined should be supervised by the Board (systemically important insurance companies), insurance companies that own a bank or savings association, and holding companies with significant insurance activities.[13] The ANPR presents one approach that would apply to systemically important insurance companies (the consolidated approach), and a second approach for less complex insurance companies that also own a bank or thrift (the building block approach).

The consolidated approach would classify the total consolidated assets and insurance liabilities of a company that is significantly engaged in insurance activities into risk segments, apply appropriate risk factors to each segment at the consolidated level, and then set a minimum ratio of required capital. The building block approach would aggregate existing capital requirements across a firm's different legal entities to arrive at a combined, group-level capital requirement, subject to adjustments to reflect the Board's supervisory objectives.

Enhanced Prudential Standards for Systemically Important Insurance Companies

In June 2016, the Board proposed a rule that would apply enhanced prudential standards to systemically important insurance companies.[14] The proposed rule would require systemically important insurance companies to comply with certain corporate governance, risk-management, and liquidity risk-management standards that are tailored to the business models, capital structures, risk profiles, and systemic footprints of those companies.

* * * *

The integrated set of enhanced prudential standards discussed above provides a more stringent regulatory regime for the largest, most complex financial institutions in the United States, and one that is designed to increase their resiliency and mitigate the risk that the failure or material financial distress of these firms could pose to U.S. financial stability.

[13] 81 FR 38631 (June 14, 2016).

[14] 81 FR 38610 (June 14, 2016).

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