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## Dodd-Frank: Enhanced Supervision Becomes Final

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**The Federal Reserve's proposed requirements for large US and non-US banking organizations to comply with enhanced supervisory requirements, required by Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, were adopted in final form on February 18 in substantially the form proposed. Several revisions address negative comments, in some cases providing significant relief, but the general requirements were unchanged. Final implementation dates were extended in order to give affected organizations additional time to come into compliance.**

The original proposals were issued in December 2011 for domestic organizations and December 2012 for non-US ones. The final regulation ("Final Regulation") covers both proposals in a revised version of Regulation YY.<sup>1</sup>

In a nutshell, the Final Regulation requires that, with important exceptions, all US and non-US banking organizations, defined as bank holding companies ("BHCs") organized

<sup>1</sup> The Final Regulation has not yet been published in the Federal Register and is available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf>. The proposals were published at 77 Fed.Reg. 594 (Jan. 5, 2012) and 77 Fed.Reg. 76628 (Dec. 28, 2012). If you wish to review discussions of the proposals, you may find our client memoranda at <http://www.shearman.com/-/media/Files/NewsInsights/Publications/2012/12/DoddFrank%20The%20Feds%20Proposal%20for%20Enhanced%20Supervi.../Files/View%20full%20memo%20DoddFrank%20The%20Feds%20Proposal%20for%20E.../FileAttachment/DoddFrankFedsProposalforEnhancedSupervisionofFor...pdf> and <http://www.shearman.com/-/media/Files/NewsInsights/Publications/2012/01/Tightening%20the%20Limits%20on%20Big%20US%20Banks/Files/View%20full%20memo%20Tightening%20the%20Limits%20on%20Big%20US%20B.../FileAttachment/TighteningtheLimitsonBigUSBanksFIA010412.pdf>.

under US law and non-US organizations that are, or are treated as, BHCs (“FBOs”), with \$50 billion or more in worldwide consolidated assets comply with the following:

- Risk-based and leverage capital requirements;
- Risk-management requirements, including the establishment of a risk management committee of the board of directors;
- Liquidity minimums, including risk-management systems, stress testing of liquidity needs, and the holding of a buffer to cover asset/liability mismatches; and
- Both supervisory and organization-run stress tests.

Subsets of these requirements apply to smaller organizations with total assets of \$10 billion or more. These requirements generally become effective on January 1, 2015, for BHCs and on July 1, 2016, for FBOs, but with transition periods for certain requirements. The requirements are calibrated to take account of the size of BHCs’ and FBOs’ operations; the larger their operations, the stricter the requirements. The only notable additional requirement applicable to the largest FBOs is to establish a US intermediate holding company (“IHC”) to hold ownership interests in US subsidiaries, which may have significant cost consequences.

The Final Regulation defers adoption of three additional requirements that had been proposed. Any non-BHC that is designated a systemically important financial institution by the Financial Stability Oversight Council (“FSOC”) will be brought within these rules in a tailored fashion when so designated. Also, single-counterparty exposure limits will await final action by the Basel Committee on Bank Supervision (“BCBS”), and early remediation requirements are also being deferred for further consideration.

Following is a summary of the requirements imposed on BHCs followed by a summary of the ones imposed on FBOs. Due to the huge number of details associated with these requirements, the summary does not purport to include all relevant points; citations to portions of the Final Regulation providing the detail are included in footnotes.

## US Organizations

For BHCs, the Final Regulation incorporated most of the provisions from the 2012 proposal with the one major exception noted above. Under the Final Regulation, enhanced prudential standards as set forth in the Final Regulation will not apply to nonbank financial companies; rather, standards for nonbank financial companies will be established following designation of those nonbank financial companies by the FSOC.

The Final Regulation generally retains almost all of the requirements of the proposal, calibrating enhanced supervision standards according to the size of the organization.

- BHCs with total consolidated assets of more than \$10 billion but less than \$50 billion must, on a semi-annual basis, conduct company-run stress tests. This requirement also applies to savings and loan holding companies and US banks with more than \$10 billion in total consolidated assets.<sup>2</sup>

<sup>2</sup> This requirement had been imposed on BHCs and US banks earlier and accordingly is effectively affirmed as part of the package of enhanced supervisory requirements. Details are in the Final Regulation at Subpart B of Regulation YY. In September 2013, the Board issued an interim final rule that clarified how bank holding companies should incorporate recent revisions to the Board’s regulatory capital rules into their capital

- In addition, those BHCs with total consolidated assets of \$10 billion or more that are publicly traded must establish risk committees that will be responsible for the oversight of the enterprise-wide risk-management practices of the company.<sup>3</sup>
  - The requirements are substantially similar to the requirements of risk committees for BHCs with consolidated assets of \$50 billion or more, summarized below.
  - The main difference lies in the qualifications for the “risk management expert” required by the Final Regulation to be a member of the risk committee. For a BHC with assets equal to or greater than \$10 billion but less than \$50 billion, an individual’s risk-management experience in a nonbanking or nonfinancial field may satisfy the requirement.
- BHCs with total consolidated assets of \$50 billion or more must:
  - Submit an annual capital plan to the Board of Governors of the Federal Reserve System (“Board”).<sup>4</sup>
    - This plan must demonstrate the BHC’s ability to maintain capital above the Board’s minimum risk-based capital ratios under both baseline and stressed conditions over a minimum nine-quarter, forward-looking planning horizon.
    - The plan must also include a discussion of the bank holding company’s sources and uses of capital reflecting the risk profile of the firm over the planning horizon.
  - Conduct semi-annual company-run and supervisory stress tests.
    - These company-run stress tests will be held in conjunction with annual supervisory stress tests run by the Board for the purpose of evaluating whether these organizations have the capital necessary to absorb losses as a result of adverse economic conditions.
    - A summary of the results of the annual supervisory stress test must be disclosed publicly by the BHC.<sup>5</sup>
  - Establish a risk-management framework.<sup>6</sup>
    - The framework must be commensurate with the company’s structure, risk profile, complexity, activities, and size, and must include policies and procedures establishing risk-management governance, risk-management practices and risk-control infrastructure for the BHC’s global operations and processes and systems for implementing and monitoring compliance with such policies and procedures.

plan and stress tests. See 78 FR 59779 (September 30, 2013). On March 5, the supervisors issued final guidance for the conduct of stress tests under this requirement, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140305a.htm>.

<sup>3</sup> Details are in the Final Regulation at Subpart C of Regulation YY.

<sup>4</sup> Details on this and stress tests, summarized in the next bullet, have applied to these BHCs since 2011 and are in the Final Regulation at Subparts E and F of Regulation YY. Heretofore they were in Subparts F and G of that regulation.

<sup>5</sup> See Section 252.58 of Regulation YY.

<sup>6</sup> Details are in the Final Regulation at Section 252.33 of Regulation YY.

- As part of the risk-management framework, BHCs must appoint a chief risk officer and establish risk committees to approve and regularly review the enterprise-wide risk-management policies of the company.<sup>7</sup>
  - The Final Regulation requires the risk committee to approve and periodically review the enterprise-wide risk-management policies of the company, rather than its risk-management practices. The Board did not adopt a proposed requirement that the risk-management framework include specific risk limitations for each business line.
  - For BHCs with total consolidated assets of \$50 billion or more, the risk committee must be a stand-alone committee and not be part of a joint committee and must receive and review regular reports from the chief risk officer at least quarterly.
- Establish and maintain a liquidity risk-management plan.<sup>8</sup>
  - The board of directors of each BHC must approve the BHC's liquidity risk tolerance at least annually.
  - In addition, the board of directors must receive and review information from senior management at least semi-annually to determine whether the BHC is operating in accordance with its established liquidity risk tolerance. This includes obtaining board approval of the liquidity risk-management strategies, policies and procedures established by senior management.
  - The plan must establish limits on potential sources of liquidity risk, including: (1) concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding and other liquidity risk identifiers; (2) the amount of liabilities that mature within various time horizons; and (3) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.
- Establish and maintain a contingency funding plan that sets out the BHC's strategies for responding to a liquidity crisis, with two components:<sup>9</sup>
  - Quantitative assessment – the BHC must identify stress events that have a significant impact on liquidity, assess the level and nature of the impact on the BHC's liquidity of such stress events, and assess available funding sources and needs during identified liquidity stress events; and
  - Event-management process – the plan must set forth procedures of managing liquidity during identified liquidity stress events.

<sup>7</sup> The risk committee must have at least one independent director, and at least one member must be a "risk management expert" who must have experience in identifying, assessing and managing risk exposures of large, complex financial firms. All risk committees of BHCs must meet at least quarterly and fully document and maintain records of their proceedings, including risk-management decisions. See Section 252.33(a)(3) of Regulation YY.

<sup>8</sup> Details are in the Final Regulation at Section 252.34(a) through (e) of Regulation YY.

<sup>9</sup> Details are in the Final Regulation at Section 252.34(f) of Regulation YY.

- Conduct liquidity stress testing in conjunction with establishing limits on liquidity risk, incorporating a minimum of three stress scenarios. These scenarios must account for (1) adverse market conditions, (2) an idiosyncratic stress event, and (3) combined market and idiosyncratic stresses.<sup>10</sup>
- In addition, the BHC must hold highly liquid assets (called the “liquidity buffer”) sufficient to meet liquidity needs as identified by the internal stress tests. The liquidity buffer must be sufficient to meet the projected net stressed cash flow need over a 30-day planning horizon of a liquidity stress test under each of the three scenarios.<sup>11</sup>
- In extraordinary cases, maintain a debt-to-equity ratio of no more than 15-to-1 if the FSOC determines that the BHC poses a “grave threat” to the financial stability of the United States.<sup>12</sup>

## Non-US Organizations

The Final Regulation includes the following significant changes from the FBO provisions of the 2012 proposal:

- The threshold of “US non-branch assets” that triggers the IHC requirement is raised to \$50 billion from \$10 billion, and the effective date changed to July 1, 2016, based on an asset total calculated as of July 1, 2015. “US non-branch assets” consist of assets of the organization’s top-tier US subsidiaries and excludes assets of any US branch or agency as well as certain non-financial companies held under special authority.<sup>13</sup>
- IHCs remain subject to US risk-based capital requirements as adopted by the Federal Reserve and with the same transition period, but are allowed to calculate and maintain risk-based capital under the standardized approach rather than the advanced approach unless an IHC chooses to do so. Also, the US leverage limits remain applicable but are not effective until January 1, 2018.
- The amount of liquid assets to be maintained by US branches and agencies as a liquidity buffer is reduced to 14 days rather than 30 days (IHCs remain subject to a 30-day liquidity buffer).
- Limits on large exposures to other counterparties are not implemented pending a final decision by the BCBS on large-exposure guidelines.

However, the Final Regulation retains the general FBO requirements of the proposal and conforms generally to analogous requirements imposed on BHCs calibrated according to the size of the organization.

<sup>10</sup> Details are in the Final Regulation at Section 252.35(a) of Regulation YY.

<sup>11</sup> See Section 252.35(b) of Regulation YY.

<sup>12</sup> Details are in the Final Regulation at Subpart U of Regulation YY.

<sup>13</sup> Assets of companies held under the authority of Section 2(h)(2) of the Bank Holding Company Act of 1956, as amended, called “Section 2(h)(2) Subsidiaries,” and subsidiaries formed to hold assets under “debt previously contracted” (or “DPC”) authority and held by a US branch or agency are excluded. Section 2(h)(2) Subsidiaries are certain US subsidiaries of non-US subsidiaries engaged in non-financial lines of business pursuant to the requirements of the statute and the Board’s Regulation K. DPC authority authorizes US banks to hold assets that would otherwise be impermissible, such as equity securities, as a result of a good-faith workout or similar arrangement for a troubled loan. See Section 252.2(i), (q) of Regulation YY.

- FBOs with \$10 billion or more in global consolidated assets but less than \$50 billion and that have publicly-traded stock must establish a risk-management committee at its parent bank focused on US operations with at least one member having “appropriate risk expertise.”<sup>14</sup>
- FBOs with more than \$10 billion in global consolidated assets but less than \$50 billion must be subject to capital stress testing requirements of the home country supervisor or internal capital stress tests reviewed by the supervisor.
  - If there is no such requirement, then the FBO must conduct stress tests of its US operations and report the results to the Board.
  - Failure to do so would subject the organization’s US branches and agencies to an asset maintenance requirement of 105 percent.<sup>15</sup>
- FBOs with more than \$50 billion in global consolidated assets but less than \$50 billion in combined US assets<sup>16</sup> must:
  - Certify to the Board that the FBO complies with its home country supervisor’s capital requirements consistent with the regulatory capital framework published by the BSCS.<sup>17</sup>
  - Establish a risk-management committee at the parent-bank level that satisfies the regulation’s requirements.<sup>18</sup>
  - Conduct internal liquidity stress tests, which may be done either globally by the FBO or for all US operations collectively, and report the results to the Board.<sup>19</sup>
  - Be subject to stress testing requirements of its home country supervisor or reviewed by the supervisor. If there is no such requirement, then the FBO must conduct stress tests of its US operations and report the results to the Board. Failure to do so would subject the FBO’s US branches and agencies to an asset maintenance requirement of 105 percent.<sup>20</sup>

<sup>14</sup> Details are in the Final Regulation at Subpart M of Regulation YY. The definition of “publicly traded” includes both instruments registered on a US exchange or on a non-US exchange registered in its home country that provides a liquid two-way market. See the Final Regulation at Section 252.2(p) of Regulation YY.

<sup>15</sup> Details are in the Final Regulation at Subpart L of Regulation YY.

<sup>16</sup> The term “combined US assets” means the sum of the consolidated assets of each top-tier US subsidiary (excluding 2(h)(2) Subsidiaries) and total assets of each US branch and agency, calculated as the average totals for the most recent four calendar quarters as reported on the Form FR Y-7Q. See Section 252.142(a)(2) of Regulation YY.

<sup>17</sup> Details are in the Final Regulation at Section 252.143 of Regulation YY.

<sup>18</sup> Details are in the Final Regulation at Section 252.144 of Regulation YY.

<sup>19</sup> Details are in the Final Regulation at Section 252.145 of Regulation YY.

<sup>20</sup> Details are in the Final Regulation at Section 252.146 of Regulation YY. The heading of this section characterizes the requirement as applying to non-US organizations with \$50 billion or more in global assets, but the text of the regulation applies it to non-US organizations with more than \$50 billion.

- FBOs with \$50 billion or more in combined US assets must:
  - Establish a risk-management committee and appoint a chief risk officer, both charged with responsibility to develop a risk-management program meeting various specific requirements in the final regulation.<sup>21</sup>
    - If the FBO does not have an IHC, it has the option of relying on the parent bank's risk-management committee so long as that committee satisfies the same requirements.
    - The chief risk officer must be located in the United States and employed by a US entity.
  - If the FBO has a US branch or agency, conduct capital stress tests annually, and report the results both to the Board and in a public disclosure, of two types:
    - Using Federal Reserve-designed scenarios, and
    - Using the organization's own scenarios.<sup>22</sup>
  - Establish a liquidity-management program, monitored by the risk-management committee, covering all US operations and appoint a chief risk officer responsible for implementing the program.<sup>23</sup>
  - Calculate liquidity requirements on a daily basis for its IHC, if one exists, and its US branches and agencies, and maintain a liquidity buffer:
    - An IHC must maintain a buffer to cover 30 days of liquidity shortfall, and
    - US branches and agencies must maintain a buffer to cover 14 days of liquidity shortfall.<sup>24</sup>
  - Conduct liquidity stress tests at least monthly for the FBO's combined US operations, US branches and agencies on an aggregate basis, and IHC if one exists, and report the results to the Board.<sup>25</sup>
  - Certify compliance by the parent bank with home country capital adequacy requirements that are consistent with the BSCS regulatory capital framework, absent which the US branch or agency would be subject to asset maintenance requirements.<sup>26</sup>
- FBOs with \$50 billion or more in US non-branch assets must form an IHC organized under US law by July 1, 2016, calculated on the basis of total assets as of July 1, 2015.<sup>27</sup>
  - The FBO's ownership interests in almost all US subsidiaries would have to be held under the IHC, and the IHC would be subject to almost all of the requirements listed above in the same way as BHCs.<sup>28</sup>

<sup>21</sup> Details are in the Final Regulation at Section 252.155 of Regulation YY.

<sup>22</sup> Details are in the Final Regulation at Section 252.158 of Regulation YY.

<sup>23</sup> Details are in the Final Regulation at Section 252.156 of Regulation YY.

<sup>24</sup> Details are in the Final Regulation at Section 252.157(c) of Regulation YY.

<sup>25</sup> Details are in the Final Regulation at Section 252.157(a) of Regulation YY.

<sup>26</sup> Details are in the Final Regulation at Section 252.154 of Regulation YY.

<sup>27</sup> Details are in the Final Regulation at Section 252.153 of Regulation YY.

- The effective date of the IHC requirement is July 1, 2016, which is one year longer than the 2012 proposal. Whether a FBO is subject to the IHC requirement will be based on its asset total as of June 30, 2015.<sup>29</sup>
- If the FBO has \$50 billion or more of US non-branch assets on July 1, 2014, it must submit a detailed plan to the Board by January 1, 2015, explaining how it plans to bring its US subsidiaries under the IHC.
  - The preamble to the Final Regulation indicates that such a plan may explain how the FBO plans to bring its total-asset number below \$50 billion for the four quarters before July 2016 in order to avoid having to establish an IHC.
- IHCs must comply with the Board's capital and leverage requirements, but (1) may use the standardized approach rather than the advanced approach if they choose, (2) must meet the capital requirements pursuant to the generally applicable transition period, and (3) must meet the leverage requirement but only as of January 1, 2018.
- IHCs must also (1) prepare and comply with annual capital plans, (2) conduct stress tests subject to the same requirements imposed on BHCs beginning in October 2017, and (3) establish a risk-management committee and appoint a chief risk officer.

The requirements above must be implemented by July 1, 2016, but with transition periods for several of them.

Finally, non-US organizations covered by Regulation YY are subject to the same special restrictions noted above in the event that the FSOC determines that the condition of the FBO poses a "grave threat" to US financial stability.<sup>30</sup>

## Conclusion

While the enhanced standards of the Final Regulation were adopted largely as proposed and are not a surprise for many BHCs and FBOs, compliance with the new standards will likely have significant, and potentially costly, effects on many global institutions. In addition to the additional compliance requirements, the IHC requirement of the Final Regulation may require, among other things, potential restructuring of the US-based operations of many FBOs to address tax related or other considerations. Further, while BHCs have been subject to increased and more frequent stress reporting, FBOs will now be required to ensure that their existing stress reporting is in compliance with the Final Regulation both in terms of the scope and frequency. In addition, while the compliance timelines have been extended by the Final Regulation, we would recommend that clients begin the process of reviewing their compliance procedures and begin efforts to implement the changes required by the Final Regulation in the near term. We will continue to follow and monitor practical impacts on clients and will keep you updated on any developments.

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<sup>28</sup> Section 2(h)(2) Subsidiaries and DPC subsidiaries held by a US branch or agency would not have to be held by the IHC.

<sup>29</sup> By July 1, 2016, all US bank subsidiaries and at least those non-bank US subsidiaries holding 90 percent or more of total non-bank assets must be transferred to the IHC. The remaining non-bank subsidiaries must be transferred by July 1, 2017. See Section 252.152(c)(2) of Regulation YY.

<sup>30</sup> Details are in the Final Regulation at Subpart U of Regulation YY.