ENHANCED PRUDENTIAL STANDARDS
On February 18, 2014 the Federal Reserve Board approved a final rule strengthening supervision and regulation of large U.S. bank holding companies and foreign banking organizations. This final rule establishes a number of enhanced prudential standards to help increase the resiliency of these covered institutions, including liquidity, risk management, and capital. The final rule also requires a foreign banking organization with a significant U.S. presence to establish an intermediate holding company over its U.S. subsidiaries in order to facilitate consistent supervision and regulation of the U.S. operations of the foreign bank.

For U.S. bank holding companies with total consolidated assets of $50 billion or more, the final rule incorporates the previously issued capital planning and stress testing requirements as an enhanced prudential standard. The rule also requires these covered companies to comply with enhanced risk management and liquidity risk management standards, conduct liquidity stress tests, and hold a buffer of highly liquid assets based on projected funding needs during a 30-day stress event. The final rule also requires publicly traded U.S. bank holding companies with total consolidated assets of $10 billion or more to establish enterprise-wide risk committees.

A foreign banking organization with combined U.S. assets of $50 billion or more will be required to establish a U.S. risk committee and employ a U.S. chief risk officer to help ensure that the foreign bank understands and manages the risks of its combined U.S. operations. These organizations will also be required to meet the same enhanced risk management standards imposed on U.S. banks through this rulemaking. Foreign banking organizations with total consolidated assets of $50 billion or more, but combined U.S. assets of less than $50 billion will be subject to enhanced prudential standards, but the capital, liquidity, risk management, and stress testing requirements will be less than those applicable to foreign banking organizations with a larger U.S. presence. The final rule also implements stress testing requirements for foreign banking organizations with total consolidated assets of more than $10 billion and risk committee requirements for foreign banking organizations that meet the asset threshold and are publicly traded.
BACKGROUND

The Dodd-Frank Act (Act) directs the Federal Reserve to establish prudential standards for bank holding companies with total consolidated assets of $50 billion or more and for nonbank financial companies that the Financial Stability Oversight Council (FSOC) has determined will be supervised by the Federal Reserve in order to prevent or mitigate risks to U.S. financial stability. The Act requires these standards to be more stringent than those standards applicable to other bank holding companies and to nonbank financial companies that do not present similar risks to U.S. financial stability. The standards must also increase in stringency based on several factors, including the size and risk characteristics of a company subject to the rule.

The prudential standards must include enhanced risk-based and leverage capital requirements, liquidity requirements, risk management and risk committee requirements, resolution planning requirements, single counterparty credit limits, stress test requirements, and a debt-to-equity limit for companies that the FSOC has determined pose a grave threat to U.S. financial stability. The Act also permits the Federal Reserve to establish other prudential standards in addition to the mandatory standards in addition to the mandatory standards, including a contingent capital requirement, enhanced public disclosures, and short-term debt limits.

On January 5, 2012 the Federal Reserve invited comment on proposed rules to implement the provisions of the Act for domestic companies. On December 28, 2012 the Federal Reserve invited comment on proposed rules to implement provisions of the Act for foreign banking organizations. The final rule makes adjustments to the two proposed rules that respond to public comments received.

FINAL RULE

The final rule implements elements of both the domestic and foreign proposals.

CAPITAL PLANNING AND STRESS TESTING

The final rule incorporates two existing standards: the previously-issued capital-planning and stress testing requirements for bank holding companies with total consolidated assets of $50 billion or more. The capital plan rule, adopted in 2011, imposed enhanced risk-based and leverage capital requirements on bank holding companies with $50 billion or more in total consolidated assets. In 2012, the Federal Reserve, jointly with the FDIC and OCC, adopted stress testing rules mandated by the Act for large bank holding companies and nonbank financial companies supervised by the Federal Reserve. These rules establish a framework for the Federal Reserve to conduct annual supervisory stress tests to evaluate whether these companies have the capital necessary to absorb losses as a result of adverse economic conditions and require these companies to conduct semi-annual company-run stress tests. The Federal Reserve...
Federal Reserve also adopted company-run stress test requirements as required by the Act for bank holding companies with more than $10 billion but less than $50 billion in total consolidated assets.

**RISK-BASED CAPITAL AND LEVERAGE REQUIREMENTS**

In July 2013 the Federal Reserve, FDIC, and OCC issued final rules implementing regulatory capital reforms reflecting agreements reached by the Basel Committee (Basel III) and certain provisions of the Act. These rules require bank holding companies with total consolidated assets of $250 billion or more or total consolidated on-balance sheet foreign exposures of at least $10 billion to meet a supplementary leverage ratio of three percent based on the international leverage standard agree to by the Basel Committee. Also in July 2013, the Federal Reserve sought public comment on a proposal that would require a U.S. top-tier bank holding company with more than $700 billion in total consolidated assets or $10 trillion in assets under custody to maintain a buffer of at least two percent above the minimum supplementary leverage requirement of three percent in order to avoid restrictions on capital distributions and discretionary bonus payments to executive officers. The Federal Reserve also expects to seek comment on additional enhancements to the risk-based capital rules for large bank holding companies in the future.

**RISK MANAGEMENT AND RISK COMMITTEE REQUIREMENTS**

The Act requires the Federal Reserve to establish enhanced risk management requirements for bank holding companies with total consolidated assets of $50 billion or more, and requires the Federal Reserve to issue regulations requiring publicly traded bank holding companies with total assets of $10 billion or more to establish risk committees. The Act mandates that the risk committee be responsible for the oversight of the enterprise-wide risk management practices of the company, to have a certain number of independent directors as members as the board determines is appropriate, and to include at least one risk management expert having experience in identifying, assessing, and managing risk exposures of large, complex firms. The Federal Reserve emphasizes that the risk committee and overall risk management requirements outlined in the final rule supplement the Federal Reserve’s existing risk management guidance and supervisory expectations, and banks should continue to follow such guidance to ensure appropriate oversight of and limitations on risk.
The Federal Reserve believes that a company’s risk committee, acting in its oversight role, should fully understand the company’s enterprise-wide risk management policies and framework and have a general understanding of the risk management practices of the company. Accordingly, the final rule 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 final rule provides that a company’s risk management 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 company’s global operations and processes and systems for implementing and monitoring compliance with those policies and procedures. The final rule requires a company to have one independent director that chairs the risk committee, but leaves to board discretion the appropriate proportion of independent directors that serve on the committee based on the company’s size, scope, and complexity. The final rule also requires that at least one member of the risk committee have risk management expertise that is commensurate with the company’s capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. For a publicly traded bank holding company with total consolidated assets equal to or greater than $10 billion but less than $50 billion, an individual’s risk management experience in a nonfinancial field may fulfill this requirement. For a bank holding company with total consolidated assets of $50 billion or more, the final rule requires that an individual have experience in identifying, assessing, and managing risk exposures of large, complex financial firms. While the final rule requires that only one member of the committee possess this experience, the Federal Reserve expects all risk committee members generally to have an understanding of risk management principles and practices relevant to the company.

The final rule requires each bank holding company with total consolidated assets of $50 billion or more to appoint a chief risk officer. The Federal Reserve expects that a bank holding company should be able to demonstrate that its chief risk officer’s experience is relevant to the particular risks facing the company and commensurate with the bank holding company’s structure, risk profile, complexity, activities, and size. Effective January 1, 2015, bank holding companies with total consolidated assets of $50 billion or more will be required to employ a chief risk officer who meets the requirements of the final rule. The Federal Reserve believes the chief risk officer...
should be held accountable for the establishment of risk limits and monitoring compliance with such limits; implementation and ongoing compliance with appropriate policies and procedures relating to risk management governance, practices, and risk controls; developing and implementing appropriate processes and systems for identifying and reporting risks, including emerging risks; managing risk exposures and risk controls; monitoring and testing risk controls; reporting risk management issues and emerging risk; and ensuring that risk management issues are effectively resolved in a timely manner.

The final rule requires that the chief risk officer report directly to the risk committee and the bank holding company’s chief executive officer. The Federal Reserve believes that this dual reporting will help the board to oversee the risk management function and may help disseminate information relevant to risk management throughout the organization. Also, Basel Committee guidance supports dual reporting. The final rule requires the compensation of a bank holding company’s chief risk officer to be structured to provide for an objective assessment of the risks taken by the company. The Federal Reserve points out that this requirement supplements existing guidance on incentive compensation, which provides that compensation for employees in risk management and controls functions should avoid conflicts of interest and that incentive compensation received by these employees should not be based substantially on the financial performance of the business units they review.

**LIQUIDITY REQUIREMENTS**

The requirements in the final rule build on the Federal Reserve’s overall supervisory framework for liquidity adequacy and liquidity risk management, which includes the Interagency Policy Statement on Funding and Liquidity Risk Management. The final rule requires the board to approve the company’s liquidity risk tolerance at least annually, receive and review information from senior management at least semiannually to determine whether the bank holding company is operating in accordance with its established liquidity risk tolerance, and to approve and periodically review the liquidity risk management strategies, policies, and procedures established by senior management. The final rule requires the risk committee or a designated subcommittee to review and approve the contingency funding plan at least annually and whenever the company materially revises the plan. Under the final rule, senior management is required to review and approve new products and business lines and evaluate liquidity costs, benefits, and risks related to...
each new business line and product that could have a significant effect on the company’s liquidity risk profile and to annually review the liquidity risk of each significant business line and product. Senior management must establish the liquidity risk limits specified in the rule and review the company’s compliance with those limits at least quarterly. Senior management must also review the cash flow projections required by the final rule at least quarterly and review and approve certain aspects of the liquidity stress testing framework at specified intervals. Senior management is required to update the risk committee or the board on a regular basis. The chief risk officer is considered a member of senior management.

Under the final rule, a bank holding company with total consolidated assets of $50 billion or more is required to establish and maintain a review function to evaluate its liquidity risk management that is independent of management functions that execute funding. The independent review function is required to review and evaluate the adequacy and effectiveness of the bank holding company’s liquidity risk management processes regularly, but no less frequently than annually. It is also required to assess whether the company’s liquidity risk management function complies with applicable laws, regulations, supervisory guidance, and sound business practices. The independent review function must also report liquidity risk management issues in writing to the board or the risk committee for corrective action. The independent review function is not required to be independent of the liquidity risk management function, but must be independent of management functions that execute funding. Stress test processes and assumptions must be subject to independent review and to review by the chief risk officer.

The final rule requires large banking companies to produce comprehensive projections that project short-term and long-term cash flows from assets, liabilities, and off-balance sheet exposures. Companies must identify and quantify discrete and cumulative cash flow mismatches over appropriate time periods, and must produce analyses that incorporate reasonable assumptions regarding the future behavior of assets, liabilities, and off-balance sheet exposures in projected cash flows and reflect the company’s capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. The company must adequately document its cash flow methodology and assumptions and conduct short-term cash flow projections daily and long-term cash flows on a monthly basis.
The final rule requires a bank holding company to establish and maintain a contingency funding plan—a compilation of policies, procedures, and action plans for managing liquidity stress events that, together, provide a plan for responding to a liquidity crisis. The contingency funding plan must include two components: a quantitative assessment and an event-management process. The final rule contains other requirements and expectations for an effective plan, including testing that would involve periodic liquidation of assets to demonstrate treasury control over assets and an ability to convert the assets into cash to be used to offset outflows.

The final rule requires large bank holding companies to establish and maintain limits on potential sources of liquidity risk, including three specified sources of liquidity risk: concentrations of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other liquidity risk identifiers; the amount of liabilities that mature within various time horizons; and off-balance-sheet exposures.

Under provisions of the final rule, large bank holding companies will be required to monitor liquidity risk related to collateral positions, liquidity risks across the enterprise, and intraday liquidity positions.

Large bank holding companies will be required to perform regular stress tests on cash flow projections. These tests must be conducted at least monthly. These companies will be required to incorporate in their stress tests a minimum of three stress scenarios that could significantly impact the company’s liquidity. Additional scenarios, based on the company’s financial condition, size, complexity, risk profile, scope of operations, or activities, should be used as needed to ensure that all of the significant aspects of liquidity risks to the company have been modeled.

The final rule requires large bank holding companies to hold highly liquid assets sufficient to meet liquidity needs as identified by the required internal stress test. This liquidity buffer must be composed of unencumbered highly liquid assets sufficient to meet projected net cash outflows for 30 days over the range of liquidity stress scenarios used in the internal stress testing. The final rule provides definitions for both unencumbered and highly liquid assets.

**DEBT-TO-EQUITY LIMITS**

The Act provides that the Federal Reserve must require a bank holding company to maintain a debt-to-equity ratio of no more than 15-to-1 if the FSOC determines that such company poses a “grave threat” to the financial stability of the U.S. and that the imposition of such requirement is necessary to mitigate the risk that such company or foreign banking organization poses to the financial stability of the U.S. The final rule provides that the debt-to-equity ratio will be calculated as the ratio of total liabilities to total equity capital minus goodwill. The final rule provides that, within 180 calendar days from the date a company receives notice that the FSOC has made a “grave threat determination”, the company is required to come into compliance with the
15-to-1 debt-to-equity ratio requirement. The final rule provides for extensions of this timeframe.

FOREIGN BANKING ORGANIZATIONS
The Act directs the Federal Reserve to establish enhanced prudential standards to prevent or mitigate risks to U.S. stability that could arise from the material financial distress or failure or ongoing activities of foreign banking organizations that have total consolidated assets of $50 billion or more. The enhanced prudential standards for foreign banking organizations must include risk-based and leverage capital, liquidity, stress test, and risk management and risk committee requirements, resolution plan and credit exposure report requirements, concentration limits, and a debt-to-equity limit for companies that pose a grave threat to U.S. financial stability. The Act also authorizes the Federal Reserve to establish a contingent capital requirement, enhanced public disclosures, short-term debt limits, and “other prudential standards” that the Federal Reserve determines are “appropriate.”

In December 2012, the Federal Reserve issued for comment its foreign banking organization rulemaking proposal. With some minor modifications, the Federal Reserve is now adopting in final form the 2012 proposal in conjunction with the final rulemaking for domestic large bank holding companies. The final rule mandates a more standardized structure for the U.S. bank and nonbank subsidiaries of foreign banking organizations in order to enhance regulation and supervision of their combined U.S. operations. Foreign banking organizations with total consolidated assets of $50 billion or more and those with combined U.S. assets of $50 billion or more will be required to establish a top-tier U.S. intermediate holding company over all U.S. bank and nonbank subsidiaries of the company (with certain exceptions). The initial compliance date for this requirement is July 1, 2016, and covered foreign banking organizations must file an implementation plan by January 1, 2015. The final rule applies the capital rules that are applicable to U.S. bank holding companies to U.S. intermediate holding companies of foreign banking organizations, including U.S. intermediate holding companies that do not have a depository institution subsidiary. U.S. intermediate holding companies with total consolidated assets of $50 billion or more will also be subject to the capital plan rule. Foreign banking organizations with total consolidated assets of $50 billion or more generally will be required to meet home country risk-based capital and leverage standards at the consolidated level.
Application of these capital requirements will occur on January 1, 2018.

The final rule will also generally apply the same set of liquidity risk management standards to the U.S. operations of foreign banking organizations with combined U.S. assets of $50 billion or more that would be required under the proposed rule for large U.S. bank holding companies. Under the final rule, the liquidity buffer will separately apply to the U.S. branch and agency network and the U.S. intermediate holding company of a foreign banking organization with combined U.S. assets of $50 billion or more. The final rule implements stress testing requirements for a U.S. intermediate holding company in a manner parallel to those required of a U.S. bank holding company.

The final rule will require any foreign banking organization with publicly traded stock and total consolidated assets of $10 billion or more and any foreign banking organization (regardless of whether its stock is publicly traded) with total consolidated assets of $50 billion or more to certify that it maintains a U.S. risk committee. In addition, a foreign banking organization with combined U.S. assets of $50 billion or more will be required to employ a U.S. chief risk officer and implement enhanced risk management requirements in a manner consistent with the domestic company standards.

The final rule provides an extended phase-in period to allow foreign banking organizations time to implement the proposed requirements. For foreign banking organizations that meet the total consolidated asset threshold of $50 billion (and, as applicable, the combined U.S. asset threshold of $50 billion as of July 1, 2015), the enhanced prudential standards required under this proposal will apply beginning on July 1, 2016. Foreign banking organizations that become subject to the requirements of the rule after July 1, 2015 will be required to form a U.S. intermediate holding company beginning on the first day of the ninth quarter after it meets or exceeds the asset threshold, unless accelerated or extended by the Federal Reserve. These foreign banking organizations will be required to comply with the enhanced prudential standards (other than stress test requirements and the capital plan rule) beginning on the same date they are required to establish a U.S. intermediate holding company, unless accelerated or extended by the board.

**NONBANK FINANCIAL COMPANIES AND OTHER MANDATES**

Although directed by the Act to establish prudential standards for FSOC-designated nonbank financial companies, the Federal Reserve has determined not to impose such standards through this final rule. The Federal Reserve has stated its intention to separately issue orders or rules imposing such standards on each nonbank financial company following
an evaluation of the business model, capital structure, and risk profile of each such company. Additionally, the final rule does not implement single-counterparty credit limits or early remediation requirements for U.S. or foreign banking organizations. The Federal Reserve has indicated that these Dodd-Frank mandates will be implemented at a later date following further study.

**EFFECTIVE DATES**

U.S. bank holding companies subject to the rule must comply by January 1, 2015. The compliance date for foreign banking organizations is July 1, 2016, one year later than originally proposed. The complete final rule can be found at the following link:

About RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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