CLEARY GOTTLIEB

ALERT MEMORANDUM

Highlights of Proposals to Tailor Enhanced Prudential Standards

November 5, 2018

Last week, the Federal Reserve Board released two proposed rulemakings to tailor the application of enhanced prudential standards to large U.S. banking organizations:

- A Board-only release that would tailor the application of prudential standards to U.S. bank holding companies (BHCs) and certain savings and loan holding companies (SLHCs); and
- A joint release with the FDIC and the OCC that would tailor the application of capital and liquidity rules.

The key substantive elements of the proposals are shown in the charts attached as Appendix A, which were included in the Board staff memo accompanying the proposals. Below we provide a brief overview of the proposed tailoring framework, as well as initial observations regarding the proposals.

The Board intends to issue a separate tailoring proposal for foreign banking organizations (FBOs) in the "near future".

Proposed Tailoring Framework

U.S. banking organizations would be divided into four categories based on size and observable risk factors, with generally less stringent requirements for those in lower tiers:

- Category I includes U.S. global systemically important banks (GSIBs);
- Category II includes any U.S. banking organization with either (i) total assets of $700bn or more or (ii) $75bn or more in cross-jurisdictional activities;
- Category III includes any U.S. banking organization with either (i) $250bn or more in total assets or (ii) $75bn or more in (a) weighted short-term wholesale funding, (b) nonbank assets or (c) off-balance sheet exposures; and
- Category IV includes any U.S. banking organization that has at least $100bn in total assets and is not in Categories I-III.

Insured depository institution (IDI) subsidiaries of BHCs or SLHCs generally would be subject to the requirements applicable to their parent's category, except for certain liquidity rules that would apply to any IDI subsidiaries that have $10bn or more in total assets.

Key Observations

- Advanced approaches capital requirements would be eliminated for three large BHCs with between $250bn and $700bn in total assets, but retained for U.S. GSIBs and one non-GSIB BHC with $75bn or more in cross-jurisdictional activity.
- While the various categories are defined by both size and risk factors, risk factors (other than GSIB status) were the determining consideration for only one institution. Nevertheless, the risk factors would create disincentives to engaging in or expanding certain practices and activities, and could affect decisions about how to structure activities within an organization.
- It appears that two institutions would become subject to additional formal requirements as a result of the proposals—the sole institution in Category II and the SLHC placed in Category III. This result contrasts with the impact for all other institutions covered by the proposals, which generally would remain subject to existing requirements or see a reduction in applicable prudential standards.
- The proposals would create a significant disincentive for institutions with between $100bn and $700bn in total assets to expand internationally.
    - Institutions in this range with cross-jurisdictional activity of $75bn or more would be elevated to Category II, and would be required to apply the advanced approaches capital and accumulated other comprehensive income (AOCI) impact requirements, full liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) requirements, annual company-run stress testing, single-counterparty credit limits and daily liquidity reporting, and would be subject to the Comprehensive Capital Analysis and Review (CCAR) qualitative assessment.
    - According to the proposals, only one U.S. institution would initially fall in Category II; that institution is smaller than all those in Category III and most in Category IV, and is significantly engaged in fiduciary activities. This institution would be scoped into the stricter Category II requirements on the basis of its cross-jurisdictional activity. Publicly available data suggests that the institution is already subject to the advanced approaches capital requirements and the CCAR quantitative assessment.
- Other risk-based indicators that can trigger stricter prudential requirements on institutions that would otherwise fall in Category IV appear to target broker-dealer activities. Some of these factors, such as short-term wholesale funding, have roots in the existing framework for enhanced capital and liquidity standards. Others, such as nonbank assets, have been less significant to those regimes.
    - While the proposals refer to the Board's view that nonbanking activities generally present greater risks than banking activities, several of the risk-based indicators suggest they may be primarily targeted at broker-dealer activities. The Board has long considered these activities to present risks not adequately addressed by the functional regulation of broker-dealers by the SEC. Otherwise, nonbanking activities would not appear to be a

significant risk factor in the context of defining categories for prudential standards. BHCs may conduct many traditional banking activities, such as commercial or consumer lending, in nonbank affiliates. And certain nonbanking activities, such as asset management, would appear to present less risk than traditional banking activities.

  - These indicators also tend to overlap (*e.g.*, broker-dealers may engage in significant short-term wholesale funding and represent a large portion of nonbank assets), suggesting that the agencies are layering disincentives to expanding securities and related activities.
  - It is also not clear that creating incentives for Category IV institutions (which otherwise do not present significant concerns from a financial stability perspective) to conduct more activities within their IDI subsidiaries versus through nonbank affiliates will create better outcomes in stress or failure scenarios.

- SLHCs with $100bn or more in assets that are not substantially engaged in insurance underwriting or commercial activities would be required to apply many of the prudential standards for the first time and to the same extent as BHCs in the applicable Category. However, according to Board data, there is currently only one SLHC with more than $100bn in assets and thus subject to the proposals' tailored standards (falling within Category III).
- Three large BHCs in Category III would gain the opportunity to opt out of the requirement to include all components of AOCI (with certain exceptions) in common equity tier 1 capital.
- The proposals would significantly reduce requirements for institutions with total assets below $250bn, most notably requiring less frequent stress testing and eliminating LCR requirements.
- In addition to a tailoring proposal specific to FBOs, the Board indicated that several other related rulemakings are pending, including in relation to resolution planning, capital planning, the "community bank leverage ratio" and so-called "Basel IV" implementation.
- While the proposals solicited input in a number of areas, the discussion did not suggest significant uncertainty about whether alternative thresholds, risk factors or standards might be more appropriate. The question that may be of greatest interest to the Board (and to commenters) is whether tailoring for non-GSIBs with $100bn or more should be based on the GSIB risk factors and resulting score, rather than the four factors and $75bn thresholds in the proposals.
- The proposals generally base categorization decisions on quantitative measures that are already reported. The determinations about where to set the thresholds appear to some extent to have been designed to achieve the resulting categorizations, i.e., the Board reviewed the metrics of various institutions (including some that failed during the crisis), and drew the lines accordingly.

Additional Observations on Categories and Risk-Based Indicators

Category III

- In addition to monitoring cross-jurisdictional activity to avoid elevation to Category II, Category III organizations would have significant incentives to manage short-term wholesale funding in order to avoid triggering the full LCR, NSFR and daily liquidity reporting (imposed within Category III on institutions that cross the short-term wholesale funding threshold).
- Significantly increasing nonbank assets or off-balance sheet exposures while in Category III would not, however, trigger any additional prudential standards under the proposals.
- The proposals would relieve Category III institutions from advanced approaches capital requirements, but not the supplementary leverage ratio.
    - The current threshold for application of the supplementary leverage ratio is the same as that for the advanced approaches capital requirements.
    - Like the advanced approaches, the supplementary leverage ratio is derived from the Basel Accord and is applied internationally. The rationale for the previous U.S. threshold focused on the international activity of an organization, as well as its size. Under the proposed categories, the most internationally active U.S. banking organizations fall into Categories I and II. However, the supplementary leverage ratio would still apply to Category III organizations as well.
    - While the agencies indicate that certain Category III institutions could have triggered the off-balance sheet exposures risk indicator (thus, suggesting that such institutions warrant the application of a leverage ratio that captures these exposures), banking institutions could also be placed in Category III based on size or the short-term wholesale funding or nonbank assets risk-based indicators.
- While the $250bn size threshold between Category III and Category IV institutions reflects the new statutory threshold for mandatory application of enhanced standards and is a traditional dividing line for many existing Board standards, many similarities exist among these institutions, raising a question of the basis for placing these institutions into different tiers (particularly when the advanced approaches threshold would be raised to $700bn). All are generally commercial banks with relatively small broker-dealer affiliates and limited cross-border activity.

Category II

- The primacy of the cross-jurisdictional activity risk-based indicator is a notable feature of the proposals. The Board explains that this focus is in part based on the potential for international activities to complicate the resolution of a BHC, taking into consideration the potential for ring-fencing by other jurisdictions in periods of stress (a somewhat ironic observation in view of the leading role the Board has played in ex ante ring fencing of international banks). Non-U.S. activities have also been a long-standing factor in determining which U.S. institutions should be subject to internationally agreed standards in the Basel Accords. Yet, it remains unclear why this risk-based indicator should be a stronger predictor of systemic risk or safety and soundness concerns than the other three identified in the proposals.

- o GSIB standards, adopted by the Board and internationally, weight cross-jurisdictional activity equally with size and the other risk-based indicators. Thus, the alternative suggested by the agencies—using the GSIB multifactor score—may have appeal, particularly to avoid undue emphasis on cross-jurisdictional activity.
- o As noted above, non-GSIBs may now seek to monitor their cross-jurisdictional activity more closely, as elevation to Category II is a significant disincentive to expansion of international activities.

Potential Implications for Foreign Banks

- The Board has indicated that it plans to address FBOs in a separate proposal. It is expected that the Board will seek to align the implementation dates of the two proposals and potentially adopt a single final rule, as it did in Regulation YY.
- One key question for the foreign bank proposal will be how the Board applies the categories to a foreign bank's U.S. operations, including intermediate holding companies.
- A number of the Board's risk factors could present particular challenges for FBOs in calculating the indicators, as several may not be included in existing U.S. regulatory reports (*e.g.*, if the Board were to require factors based on combined U.S. operations).
- The overweighting of cross-jurisdictional activities could be significant when applying the categories to foreign banks, especially to their combined U.S. operations.

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If you have any questions concerning this memorandum, please reach out to your regular firm contact or any of the following:

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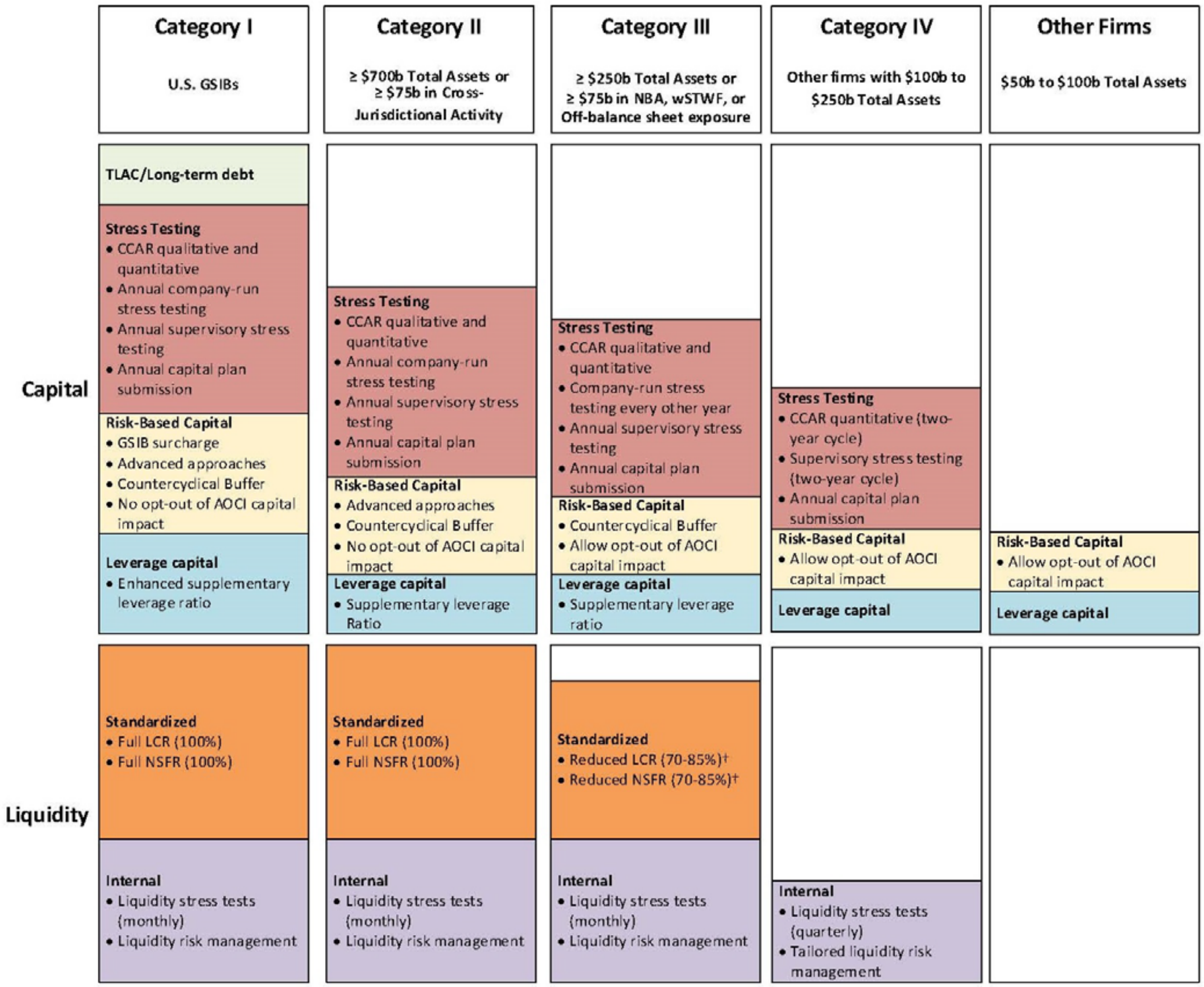
Appendix A

Proposed Requirements*



* This figure does not reflect risk committee and related risk management requirements or single-counterparty credit limits.

* For firms subject to Category III requirements with wSTWF of $75 billion or more, 100% LCR and NSFR requirements would apply. For firms subject to Category III requirements with less than $75 billion in wSTWF, the proposal would request comment on reducing the LCR and NSFR requirements to a level between 70-85%.

Glossary: NBA – nonbank assets; wSTWF – weighted short-term wholesale funding; AOCI – accumulated other comprehensive income; CCAR – Comprehensive Capital Analysis and Review; GSIB – global systemically important bank holding company; LCR – liquidity coverage ratio rule; NSFR – net stable funding ratio proposed rule; TLAC – total loss-absorbing capacity.

List of Firms by Projected Category*

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

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