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Legal Update
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Federal Reserve Issues Final Regulation Implementing Dodd-Frank Section 165 Enhanced Prudential Standards for Large US and Non-US Banking Organizations

Introduction

On February 18, 2014, the Board of Governors of the Federal Reserve System (FRB) approved a final rule (Final Rule) implementing the enhanced prudential standards contained in section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) for US bank holding companies (BHCs) and foreign banking organizations (FBOs).[1] The Final Rule and accompanying preamble comprise over 400 pages and, despite substantial criticism of the proposals, in many respects closely track the separate proposals for large US BHCs (Domestic Proposal) and for large FBOs (FBO Proposal) issued by the FRB in December 2011 and December 2012, respectively.[2] Thus, under the Final Rule, US BHCs and FBOs with at least $50 billion in total consolidated assets will be subject to heightened capital, liquidity, risk management, and stress testing requirements. These requirements will generally take effect for US BHCs on January 1, 2015, and for FBOs on July 1, 2016. For a summary of the requirements that apply to various categories of FBOs and BHCs, please see the attached Tables 1 and 2.

While the Final Rule adopts many aspects of the Domestic and FBO Proposals, there are several important changes. First, the Domestic and FBO Proposals would have limited the credit exposure of large BHCs and FBOs to unaffiliated counterparties. This single counterparty credit limit proposal generated significant comment and the FRB deferred final action on this aspect of the enhanced prudential standards, noting that it continues to work on developing those limits in light of comments received on the proposal. The FRB indicated it also plans to take into account the Basel Committee on Bank Supervision's (BCBS) efforts on its pending "large exposure" proposal, as well as the results of the FRB's quantitative impact study of its own earlier proposal.[3]

Second, both of the proposals would have implemented the requirements of section 166 of the Dodd-Frank Act in addition to those specified in section 165. Section 166 of the Dodd-Frank Act requires the FRB to implement an early remediation regime for nonbank financial companies designated as systemically important financial institutions and bank holding companies with total consolidated assets equal to or greater than $50 billion. In the FBO Proposal, the FRB sought to extend the early remediation regime to the US operations of FBOs with at least $50 billion in consolidated global assets. These early remediation provisions also were not included in the Final Rule, with the FRB again indicating that it continues to review comments on its earlier proposal and that those provisions "remain under development."

Third, the proposals provided that the section 165 enhanced prudential standards that apply to BHCs and FBOs would serve as a baseline for the enhanced prudential standards to be applied to US and non-US nonbank financial companies designated for FRB supervision by the Financial Stability Oversight Council (Council). In response to commenters' substantial objections, the FRB acknowledged that companies designated by the Council for FRB supervision may have a range of businesses, structures, and activities that present differing risk profiles. As a result, rather than apply the Final Rule to those companies, the FRB decided that it would instead thoroughly evaluate the characteristics of a designated company and tailor the application of the enhanced prudential standards to those companies by order or regulation. While this approach was taken to ease the concerns of US and non-US companies that may be designated for FRB supervision, the extent to which affected companies will have an opportunity to provide input on the development of those standards outside a formal notice and comment process remains unclear.

A very controversial aspect of the FBO Proposal was the requirement that FBOs with global assets of $50 billion or more and US assets of $10 billion or more consolidate US subsidiary activities under a US intermediate holding company (IHC) that would be subject to the same enhanced prudential standards as BHCs. This proposal was vigorously opposed by international banks and non-US governmental authorities on a number of grounds, including that (i) it was not authorized under section 165; (ii) it was contrary to the well-settled principle of national treatment; (iii) it would encourage non-US governments to impose similar or more burdensome requirements and undermine efforts to develop common global prudential standards; and (iv) it would encourage non-US banks to scale back or even terminate their US operations, thus harming the US economy. Although the FRB retained and vigorously defended the IHC requirement in the Final Rule, it did raise the threshold for establishment from $10 billion to $50 billion in US non-branch assets, delay the application of US leverage capital standards to IHCs until January 1, 2018, and extend the initial compliance date for the IHC and other enhanced prudential standards for FBOs for one year until July 1, 2016. Despite these accommodations, the IHC provision stands as a fundamental departure from the US regulatory approach that historically provided non-US banks with significant flexibility to choose how to structure their US banking and nonbank operations. The FRB's decision to impose the IHC requirement on FBO subsidiary operations reflects a trend away from "national treatment" and deference to home country supervisors and raises serious policy and competitive equity issues not all of which can be justified on the basis of ensuring US financial stability. Notably, after the Final Rule's release, Michel Barnier, the European Union's financial services chief, indicated that the Final Rule may cause other jurisdictions to retaliate by imposing similar measures, and that he would seek talks with the FRB on the longer term consequences of the IHC on competitive equality for non-US banks.[4]

The IHC requirement is already beginning to cause FBOs to reduce or otherwise restructure their US operations to minimize the impact of some of the more onerous aspects of the Final Rule,[5] and it may lead other jurisdictions to impose similar requirements on US and non-US banks operating locally. In its effort to strengthen financial stability, the FRB may limit market options and reduce foreign investment and potential sources of credit and employment in the US and perhaps even global markets. Indeed, in the preamble to the Final Rule, the FRB acknowledged that if a large FBO "were to reduce its systemic footprint in response to the final rule, this would be consistent with the [FRB's] overall goal of financial stability."[6]

In addition to the IHC requirement, the Final Rule imposes enhanced risk-based and leverage capital, liquidity, risk management, and stress-testing requirements on large FBOs with US operations, as described in detail below. As is the case for domestic BHCs, the Final Rule imposes a risk committee requirement on FBOs that are publicly traded with total consolidated assets of $10 billion or more. Additionally, stress testing requirements would be imposed on all FBOs and foreign savings and loan holding companies with total consolidated assets of $10 billion, regardless of whether they are publicly traded. For BHCs, many aspects of the enhanced prudential standards contemplated by section 165 of Dodd-Frank, including capital planning and stress testing requirements, have already been implemented. As a result, these provisions are simply incorporated into the Final Rule by reference. However, the Final Rule imposes new enhanced liquidity and risk management standards on top-tier BHCs with total consolidated assets of $50 billion or more. Although the full array of risk management standards would not apply, BHCs that are publicly traded with consolidated assets of at least $10 billion would be required to establish risk committees.

As BHCs and FBOs grapple with the added compliance burdens of the Final Rule, its implications, particularly for FBOs, will become clearer over time. The FRB has said that it will evaluate reorganizations that result in the movement of US assets from FBO subsidiaries to branches. In this regard, institutions with subsidiary operations near the asset thresholds specified in the Final Rule may pursue strategies intended to put them below the thresholds.

This Update provides an overview of the significant components of the Final Rule for BHCs and FBOs.

Intermediate Holding Company

As noted above, one of the most controversial aspects of the FBO Proposal was the requirement for certain large non-US banks to consolidate nearly all US non-branch operations under a separately capitalized intermediate holding company that would be subject to prudential standards equivalent to those that apply to US bank holding companies. The FRB retained the IHC requirement in the Final Rule, but made two important concessions. First, the FRB increased the asset threshold that triggers the IHC formation requirement from $10 to $50 billion in US non-branch assets for an FBO having $50 billion or more in total consolidated assets. By doing so, according to its own estimate, the FRB reduced the number of FBOs that would be covered by the IHC requirement from approximately 25 to 30 firms to between 15 and 20. Second, the FRB lengthened the transition period for forming an IHC in order to provide additional time to address tax and other IHC-related reorganization issues. Like the Proposal, the Final Rule exempts US branches and agencies from the IHC requirement.

Key highlights and considerations relating to the final IHC requirement include the following:

- **Calculation of $50 Billion Threshold.** An FBO must calculate its US non-branch assets for purposes of applying the US IHC requirement by taking the average of the total consolidated assets of each top-tier US subsidiary of the FBO for the four previous quarters. The FRB justified the scope of the subsidiaries and assets to be included in the calculation on the basis that it is similar to the methodology used by a US BHC to measure its total consolidated assets for purposes of Section 165. Excluded from this calculation are subsidiaries held through BHCA Section 2(h)(2) authority.[7] In response to comments, the Final Rule includes an additional exception for subsidiaries of US branches or agencies (US Branches) that were acquired or formed to hold assets acquired in the ordinary course of business for the sole purpose of securing debt previously contracted (DPC). The FRB excluded DPC branch subsidiaries

on the basis that the associated liabilities pertain to the US Branch, which is held outside the IHC, and because DPC assets may only legally be held for a short time. For purposes of determining the $50 billion threshold, the Final Rule provides for netting of intercompany balances among the US subsidiaries. Accordingly, FBOs will reduce their US non-branch assets by the amount corresponding to any balances and transactions between any top-tier US subsidiaries that would be eliminated in consolidation if an IHC were already in existence. However, the FBO may not exclude intercompany balances and transactions between US subsidiaries and US Branches or between the US subsidiaries and non-US affiliates.

- **Covered US Subsidiaries.** Despite vigorous opposition by commenters, the Final Rule retains the BHCA definition of control for purposes of identifying subsidiaries that would have to be transferred to an IHC. An FBO is deemed to "control" a US company if it (i) directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25% or more of any class of voting securities of the company; (ii) controls in any manner the election of a majority of the directors or trustees of the company; or (iii) directly or indirectly exercises a controlling influence over the management or policies of the company.[8] The FRB justified this approach as necessary to ensure parity of treatment between FBOs and US BHCs. Additionally, the FRB noted that the extended transition period provided in the Final Rule should allow FBOs time to gather necessary information on subsidiary holdings.

An FBO that meets the US non-branch asset threshold must hold its interest in any US subsidiary, other than exempted subsidiaries, through its IHC. An IHC must also hold non-US subsidiaries held through US subsidiaries, as well as subsidiaries of US branches and agencies (other than DPC subsidiaries) of the FBO. In addition, the FBO must transfer the entirety of its ownership interests in a US subsidiary to the IHC, and may not retain any ownership interests directly or through other subsidiaries. Despite calls to do so, the FRB made no exceptions for de minimis subsidiaries, merchant banking subsidiaries, subsidiaries that function as funding conduits, and US subsidiaries engaged in or holding nonfinancial assets (such as private equity investments in nonfinancial assets). All must be held by the IHC.

- **Exemption Requests.** The Final Rule acknowledges that the application of the BHCA control definition may not be appropriate in all cases and thus provides a mechanism for FBOs to seek an exemption from inclusion within the IHC structure of specific subsidiaries through the submission of a formal written request. Requests must be submitted to the FRB 180 days before the FBO must form an IHC. The request must detail why it should be granted (e.g., the FBO should give information that demonstrates that it cannot transfer its ownership interest in the subsidiary to the IHC or cannot otherwise restructure its investment). If the FRB grants an exemption, the FRB may require passivity commitments or other supervisory agreements to limit the exposure to, and transactions between, the IHC and the US subsidiary that is held outside the IHC.
- **Implementation Plan.** An FBO must provide the FRB with an after-the-fact notice after it has formed its IHC. While the Final Rule does not require FBOs to obtain prior approval in order to form an IHC, they are required to submit by January 1, 2015 an implementation plan outlining the FBO's proposed process to comply with the Final Rule's IHC requirements. The FRB envisions that the implementation plan will facilitate dialogue between the FRB and the FBO.

Implementation plans must include: (i) a list of the FBO's US subsidiaries, including detailed information on those US subsidiaries it does not have to hold through the US IHC (i.e., the name, asset size, and a description of why the US subsidiary is a Section 2(h)(2) company or DPC branch subsidiary), or for which the FBO intends to seek an exemption; (ii) a projected timeline for the transfer by the FBO of its ownership interest in those subsidiaries to the IHC; (iii) a timeline of all planned capital actions or strategies for capital accumulation that will facilitate the IHC's compliance with the risk-based and leverage capital requirements applicable to the IHC (discussed below); (iv) quarterly pro forma financial statements for the IHC; and (v) a description of the risk management and liquidity stress testing practices of the FBO's combined US operations, and how the FBO and IHC plan to comply with those requirements. The FRB may request additional information, and the FBO should update the FRB if it will deviate materially from its submitted plan.

- **Timing of Compliance.** If an FBO meets or exceeds the US non-branch asset threshold on July 15, 2015, an IHC will be required to hold the FBO's ownership interest in any US BHC subsidiary, any depository institution subsidiary, and US subsidiaries representing 90% of the FBO's assets not held under the BHC or depository institution by July 1, 2016. The FBO has until July 1, 2017 to transfer any remaining US subsidiaries to its IHC. The FRB also extended the compliance period for FBOs who meet or exceed the asset threshold for formation of an IHC after July 15, 2015. Those FBOs would have until the first day of the ninth quarter after they meet or exceed the threshold to establish a US IHC.
- **Timing of Compliance/Applicable Standards for BHC Subsidiary of FBO.** As in the FBO Proposal, a US BHC that is designated as an IHC will be subject to the applicable US IHC enhanced prudential standards, and not to applicable US BHC enhanced prudential standards. However, prior to the formation of the IHC, a US BHC with total consolidated assets of $50 billion or more that is controlled by an FBO will be subject to the enhanced prudential standards applicable to US BHCs as of January 1, 2015. The US BHC will shift over to the IHC standards on the date that the US BHC becomes subject to the parallel requirements for IHCs under the Final Rule (e.g., generally, July 1, 2016; but October 1, 2017 for capital stress test requirements and January 1, 2018 for leverage capital requirements).
- **Alternative Organization Structures.** The Final Rule gives the FRB authority to permit an FBO to establish multiple IHCs or to use an alternative organizational structure to hold its US operations (e.g., when an FBO controls multiple lower-tier FBOs that have separate US operations or when, pursuant to home country law, the FBO may not control its US subsidiaries through a single IHC). If the FRB authorizes the formation of multiple IHCs, it will treat each IHC as if it had $50 billion or more in total consolidated assets, even if its assets are below that threshold. The FRB will not permit an alternative structure where the purpose or primary effect would be to reduce the impact of the FRB's capital rules or other prudential requirements (e.g., forming an IHC for the sole purpose of holding a nonbank subsidiary separate from banking operations, or to designate a company that is not the top-tier US company as the IHC). Not surprisingly, the FRB did not adopt the "virtual" IHC concept proposed by some commenters.
- **Corporate Form, Designation of Existing Company, and Dissolution of US IHC.** The Final Rule requires an IHC to be organized under the laws of the United States, any of the fifty US states, or the District of Columbia, and provides FBOs

flexibility with respect to the corporate form for the IHC. The FRB clarified that the US IHC may not be a foreign legal entity. The FRB also clarified that an FBO may designate an existing entity as the IHC, provided that it is the top-tier US entity.

If its US assets fall below the applicable threshold for four consecutive quarters, an FBO may dissolve the US IHC, but it must reestablish the IHC if the FBO's US non-branch assets subsequently exceed the $50 billion threshold for four consecutive quarters. As a practical matter, given the cost of establishing an IHC and restructuring its US holdings, an FBO would likely not dissolve its US IHC even if it could, unless it were making material changes in its US business.

- **Source of Strength.** The FRB confirmed in the preamble to the Final Rule that an IHC will not be required to serve as a source of strength for its subsidiaries that are not insured depository institutions.
- **Reservation of Authority.** The FRB reserved its authority to modify the application of the enhanced prudential standards during the transition period if appropriate to accommodate an FBO's organizational structure or to accommodate characteristics specific to that FBO, and if the modification is consistent with other relevant considerations. The FRB also retains authority to address "idiosyncratic issues and discontinuities" that may arise out of the application of the enhanced prudential standards to the US operations of FBOs. In addition, the FRB has cautioned that it intends to monitor any attempted evasions of the IHC requirements by FBOs (e.g., through the transfer of assets and activities by FBOs into their US branches and agencies), although the FRB indicated that the potential for such transfers would be limited because most non-branch activities are impermissible for a branch (e.g., broker-dealer activities, or activities funded by FDIC-insured deposits that cannot be moved into a branch unless the branch is a grandfathered insured branch).
- **Legal Authority.** As noted above, the FRB responded to comments that FRB did not have authority to adopt an IHC requirement by relying on the provision in Section 165 of Dodd-Frank that permits the FRB to establish any prudential standard for covered companies if the FRB determines it is appropriate. In the Final Rule, the FRB has determined it is appropriate, within the purpose of Section 165, to establish the IHC requirement because it directly addresses risks to US financial stability by increasing the resiliency of US operations of large FBOs. The FRB also stated (in what is a common theme throughout the Final Rule) that the IHC requirement creates a level playing field between domestic BHCs and FBOs, in furtherance of national treatment and competitive equality.

Risk-Based and Leverage Capital Requirements

The Final Rule adopts enhanced risk-based and leverage capital requirements for IHCs, parent FBOs, and domestic BHCs substantially as proposed. Most significantly, the FRB essentially rejected the arguments of non-US stakeholders against the imposition of local capital requirements on the US operations of FBOs, including those comprised primarily of broker-dealer and other nonbank operations. This approach appears consistent with the FRB's view, noted above, that if an FBO "were to reduce its systemic footprint" in response to the Final Rule, for example, by shedding US assets, "this would be consistent with the Board's overall goal of financial stability."[9] In addition, the FRB generally acknowledged that the imposition of local capital requirements at the IHC level, including the potential need to raise additional capital through the sale of equity in US IHCs, could result in a reduction of FBO capital for purposes of parent-only or even

consolidated capital calculations, forcing some FBOs to raise additional capital in order to satisfy home country requirements. However, the FRB reasoned that requiring FBOs to maintain capital within the United States sufficient to satisfy US requirements is nevertheless an appropriate step to protect US financial stability in accordance with the mandate of the Dodd-Frank Act.

FOREIGN BANKING ORGANIZATIONS

Intermediate Holding Companies

- **Capital Requirements.** As proposed, IHCs will generally be required to hold capital sufficient to satisfy the same US risk-based and leverage capital rules that apply to US BHCs. Accordingly, IHCs must satisfy US Basel III minimum capital requirements, including the capital conservation and (to the extent applicable) the countercyclical capital buffer.[10] IHCs will also be subject to the US "generally-applicable" leverage ratio (4 percent) and, in the case of IHCs with total consolidated assets of $250 billion or more or $10 billion or more in on-balance sheet foreign exposure, the "supplementary" leverage ratio based on Basel III (3 percent, including off-balance sheet exposures). IHCs will also be subject to the same capital planning requirements as US BHCs under the FRB's Comprehensive Capital Analysis and Review (CCAR) framework, pursuant to which each IHC must submit an annual capital plan to the FRB that demonstrates the IHC's ability to maintain capital above the US Basel III minimum risk-based capital ratios under both baseline and stressed conditions over a minimum nine-quarter time horizon, taking into account any planned capital distributions. The capital stress testing requirements that will apply to IHCs under CCAR are described separately below.
- **Advanced Approaches Exemption for Certain IHCs.** Notwithstanding that IHCs will generally be subject to the same capital rules as US BHCs, the Final Rule exempts IHCs that would otherwise be subject to the US Basel III "advanced approaches" risk-based capital rules (i.e., those with total consolidated assets of $250 billion or more or $10 billion or more in on-balance sheet foreign exposure) from needing to comply with those more complex requirements. With prior FRB approval, this relief from application of the US advanced approaches rules is available even to an IHC that has a US bank subsidiary and is itself a BHC otherwise subject to the advanced approaches rule.[11] However, IHCs meeting the threshold for applicability of the advanced approaches rules generally will still be subject to other aspects of the US Basel III rules applicable to advanced approaches banks, such as the countercyclical capital buffer, the supplementary leverage ratio, and the requirement to include accumulated other comprehensive income (AOCI) in regulatory capital.
- **Timing of Compliance.** In addition to the general extension of the compliance date of the Final Rule for FBOs to July 1, 2016, the minimum leverage ratios for IHCs (both the generally-applicable leverage ratio and the supplementary leverage ratio) will not apply until January 1, 2018. According to the FRB, this transition period "should help [FBOs] manage the costs of moving capital to the United States." However, the FRB specifically reserves the right to accelerate application of the leverage ratio requirements to an IHC if it believes the FBO has taken actions to evade the IHC capital requirements.
- **Disclosure Obligations.** Although IHCs are technically subject to the same quarterly public disclosure obligations as apply to BHCs under US Basel III, the FRB expects that most IHCs will be able to rely on an exemption from this disclosure obligation that applies to any subsidiary of an FBO that is subject to

"comparable public disclosure requirements in its home jurisdiction."[12]

FBOS with $50 Billion or More in Total Consolidated Assets

- **Capital Requirements.** The Final Rule also adopts, largely as proposed, the requirement that FBOs with $50 billion or more in total consolidated assets (including those required to establish IHCs) certify or demonstrate compliance with home-country capital standards that are consistent with the Basel capital framework, which the Final Rule defines to include all Basel III minimum risk-based capital ratios, the Basel III 3 percent supplementary leverage ratio (but not the US 4 percent leverage ratio), and all restrictions arising in connection with applicable Basel III capital buffers. If a particular home country jurisdiction has not established capital adequacy standards consistent with Basel III, the FBO would be required to demonstrate to the satisfaction of the FRB that it would meet or exceed Basel III standards on a consolidated basis.
- **Consequences of Failure to Comply.** The Final Rule authorizes the FRB to impose restrictions on the US operations of any FBO that fails to satisfy the capital certification (or demonstration) requirement. However, the Final Rule incorporates an industry request that the FRB provide notice to an FBO and an opportunity to respond before imposing any such restrictions on the FBO's US operations.
- **Amendments to FR Y-7Q.** The FRB intends to propose for public comment amendments to the FR Y-7Q that would incorporate information reporting requirements related to the parent-level capital adequacy of large FBOs.

FBOs with Total Consolidated Assets of Less than $50 Billion

- **No Capital Requirements Imposed.** The Final Rule does not impose specific capital requirements on FBOs with total consolidated assets of less than $50 billion. As discussed below, however, FBOs with total consolidated assets between $10 billion and $50 billion will be subject to certain requirements related to home-country capital stress testing.

US BANK HOLDING COMPANIES

- **Large BHC Capital Requirements.** The Final Rule requires US BHCs with $50 billion or more in total consolidated assets to meet all applicable US regulatory capital requirements, including the US Basel III rules adopted in 2013, any enhanced US supplementary leverage buffer requirement ultimately adopted for the handful of largest and most complex US BHCs, and any risk-based capital surcharges ultimately adopted for any US BHCs that are global systemically important banks (G-SIBs) pursuant to the BCBS's G-SIB regime.[13] The Final Rule also simply incorporates the previously issued capital planning and stress testing requirements for large BHCs discussed above in connection with the IHC capital requirements.[14]
- **Mid-Tier BHC Capital Requirements.** US BHCs with less than $50 billion in total consolidated assets are not subject to the enhanced prudential standards of the Dodd-Frank Act, including with respect to capital. Of course, they remain subject to the applicable US Basel III requirements which apply to all BHCs with more than $500 million in assets. Moreover, the Final Rule also incorporates the previously issued capital stress testing requirements for US BHCs with total consolidated assets between $10 billion and $50 billion, as discussed below.

Risk Management and Risk Committee Requirements

The Final Rule largely adopted as proposed risk management and risk committee requirements for FBOs and BHCs (including the requirement for larger FBOs and BHCs to appoint a chief risk

officer). The FRB noted that in large measure the requirements were specifically required by Section 165(h) of the Dodd-Frank Act and were needed to address the risk-management weaknesses observed during the financial crisis. The Final Rule represents the first time that large BHCs and FBOs will be required by regulation to comply with specific US risk management standards. While the failure to comply with regulatory requirements can have specific supervisory consequences, in many respects the mandatory aspects of the Final Rule, such as the establishment of risk management committees or the appointment of chief risk officers, are requirements that major banks have been implementing for some time under existing regulatory guidance and as a matter of best practices. In implementing the requirements for FBOs and BHCs, the FRB's intention is to achieve equivalent, if not identical, standards for each.

FOREIGN BANKING ORGANIZATIONS

FBOs with Combined US Assets of $50 Billion or More

- **US Risk Committee Requirements.** An FBO with combined US assets of $50 billion or more must establish a US risk committee that oversees the risk management function for its combined US operations (branch and non-branch operations). The risk committee must aggregate, monitor and report risks across all US legal entities, and assist US supervisors to understand risks posed to US financial stability by the US operations of FBOs. The FRB explained that it is not necessary that large FBOs certify to the FRB that they have established a risk committee, because the FRB will obtain all the information it requires through the supervisory process for these FBOs. At least one risk committee member must be independent.[15]
- **Responsibilities of US Risk Committee.** The US risk committee must periodically review and approve the risk-management policies of the combined US operations and oversee the operation of an appropriate risk-management framework commensurate with the capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors of the FBO's combined US operations. The US risk-management framework must be consistent with the enterprise-wide risk management policies, and must include enumerated policies, procedures, processes, and systems. An FBO may rely on its parent company's enterprise-wide risk management policies, as long as those policies fulfill the minimum requirements established by the Final Rule. The US risk committee must meet at least quarterly and fully document and maintain records of its proceedings, including risk-management decisions.
- **Risk Management Expertise.** At least one risk committee member must have risk-management expertise that is commensurate with the FBO's capital structure, risk profile, complexity, activities, size, and other appropriate risk-related factors. Risk management expertise is defined as "experience identifying, assessing and managing risk exposures," and such experience must be gained in large financial firms. All risk committee members must have an understanding of risk management principles and practices relevant to the company.
- **Placement of Risk Committee.** The US risk committee may be a committee of the FBO's global board of directors (on a stand-alone basis or jointly with its enterprise-wide risk committee) or, if the FBO is subject to the IHC requirement, as a committee of the IHC's board of directors. An IHC must have its own risk committee, which may also fulfill the responsibilities of the US risk committee. The requirement of an IHC to have its own risk committee may create an incentive to place

the US risk committee at the IHC rather than the FBO level.

- **US Chief Risk Officer Responsibilities.** The US chief risk officer must operate under dual reporting lines to the US risk committee and the global chief risk officer. The US chief risk officer will serve as a single point of contact for the FRB supervisory staff. The chief risk officer may execute his or her responsibilities by working with, or through, others in the organization, including business units. In response to comments, the Final Rule permits the chief risk officer to "oversee" the execution of certain responsibilities, rather than be directly responsible for them.

  The US chief risk officer is responsible for overseeing (i) measurement, aggregation, and monitoring of risks undertaken by the combined US operations; (ii) implementation of and ongoing compliance with the FBO's risk management policies and procedures for its combined US operations, and the development and implementation of processes and systems for implementing and monitoring compliance with the policies and procedures; and (iii) management of risks and risk controls, and monitoring and testing of such risk controls.

- **US Chief Risk Officer Qualifications.** A US chief risk officer must have risk-management expertise, gained in a large, complex financial firm, commensurate with the capital structure, risk profile, complexity, activities, and size of the FBO's combined US operations.

- **US Chief Risk Officer Reporting Requirements.** In fulfilling his or her dual reporting obligations, the chief risk officer is required to report on the nature of and changes to material risks undertaken by the FBO's combined US operations, including risk management deficiencies and emerging risks, and how those risks relate to the global operations of the company. The chief risk officer may not fulfill other roles within the FBO, including functioning as the global risk officer; rather, US risk management oversight should be his or her primary responsibility.

- **Compensation of US Chief Risk Officer.** Compensation of the US chief risk officer must be consistent with providing an objective assessment of risks.

- **Location of US Chief Risk Officer.** In order for the US chief risk officer to have appropriate exposure to the FBO's US operations, and to ensure accessibility to US supervisors, the US chief risk officer must be located in the United States, and employed by a US subsidiary or US office of the FBO.

- **Failure to Comply.** If an FBO fails to comply with the risk management requirements, the FRB may impose restrictions, conditions, or requirements on the activities or business operations of the FBO's combined US operations.

FBOs with Total Consolidated Assets of $50 Billion or More But Combined US Assets of Less than $50 Billion

- **Responsibilities of FBO and Certification to FRB.** An FBO with total consolidated assets of at least $50 billion but combined US assets of less than $50 billion must certify to the FRB on an annual basis concurrently with the FBO's FR Y-7 that it maintains a US risk committee of its board of directors (or equivalent) that (i) oversees the US risk-management policies of the combined US operations of the company, and (ii) has at least one member of the risk committee with risk management expertise in large, complex firms (which may be nonfinancial or nonbanking firms). To accommodate diversity in corporate governance practices across different jurisdictions, FBOs in this category do not need to meet any standards of independence with respect to members of the risk committee. The Final Rule requires the FBO to take appropriate measures to ensure that its combined US operations implement

the risk management policies overseen by the US risk committee, and that its combined US operations provide the US risk committee sufficient information to carry out its responsibilities.

- **Placement of Risk Committee.** The risk committee must be a committee of the global board of directors.
- **Failure to Comply.** As with an FBO with combined US assets of $50 billion or more, if an FBO fails to comply with the risk management requirements, the FRB may impose restrictions, conditions, or requirements on the activities or business operations of the FBO's combined US operations. If the FRB determines to take action due to an FBO's noncompliance, the FRB will notify the FBO and describe the basis for taking such action. Within 14 calendar days or receipt, the FBO may request reconsideration, and the FRB will respond to that request prior to taking the action.[16]

Publicly Traded FBOs with Total Consolidated Assets of $10 Billion or More but less than $50 Billion

- **Responsibilities of FBO and Certification to FRB.** A publicly traded FBO[17] with total consolidated assets of $10 billion or more (but less than $50 billion) has the same risk committee requirements as detailed above for FBOs with at least $50 billion in total consolidated assets but less than $50 billion in US assets. Total consolidated assets for purposes of the risk management requirement are calculated as the average of the total assets for the two most recent periods as reported on the FBO's FR Y-7.
- **Timing of Compliance.** In general, an FBO subject to this section must comply with its requirements beginning on the first day of the ninth quarter either on the date its total consolidated assets are at least $10 billion, or on the date on which any class of stock or similar interest becomes publicly traded, whichever is later. An FBO may cease compliance with this section if its total consolidated assets fall below $10 billion for four consecutive calendar quarters, if its total consolidated assets are at least $50 billion and it becomes subject to the requirements at that level, or if it ceases to be a publicly traded FBO.

US BANK HOLDING COMPANIES

BHCs with Total Consolidated Assets of $50 Billion or More

- **Risk Committee Requirements.** A BHC with total consolidated assets of $50 billion or more must establish an enterprise-wide risk committee with the same risk management framework, member qualifications, and responsibilities as smaller BHCs, as discussed below. However, for large BHCs, the risk committee's responsibilities also include liquidity risk management. A BHC also must appoint a chief risk officer.
- **Corporate Governance Requirements.** In addition to the corporate governance requirements for smaller BHCs, the risk committee must (i) be an independent committee with risk management oversight as its sole function; (ii) report directly to the BHC's board of directors; and (iii) receive and review regular reports at least quarterly from the BHC's chief risk officer. The BHC's parent company's risk committee may still serve as risk committee for one or more of its subsidiaries as long as the requirements of the Final Rule are met.
- **Chief Risk Officer Qualifications and Responsibilities.** The chief risk officer must have risk management expertise in a large, complex financial firm. The chief risk officer is responsible for overseeing: (i) the establishment of risk limits and monitoring compliance with those limits; (ii) the implementation and ongoing compliance with appropriate policies and procedures for risk management governance, practices, and controls, including emerging risks; (iii) managing risk exposures

and risk controls; (iv) monitoring and testing risk controls; (v) reporting risk management issues and emerging risks; and (vi) ensuring that risk management issues are timely and effectively resolved. In response to comments, the chief risk officer is no longer required to have "direct" oversight over the enumerated responsibilities. Under the Final Rule, the chief risk officer may execute his or her responsibilities by working with, or through, others in the organization, including delegating responsibilities to business units.

- **Reporting Requirements and Corporate Governance for Chief Risk Officer.** The chief risk officer must report directly to both the risk committee and the chief executive officer of the BHC. Compensation for the risk officer must be structured to provide for an objective assessment of the risks taken by the company. The FRB acknowledged that a BHC may use discretion in adopting a compensation structure for its chief risk officer, so long as the compensation structure provides for an objective assessment of risks.
- **Timing for Chief Risk Officer.** The requirements to appoint a chief risk officer, including the risk management expertise requirement, will take effect on January 1, 2015, although as a practical matter, most large BHCs already have qualified chief risk officers in place.

Publicly Traded BHCs with Total Consolidated Assets of More than $10 Billion but Less than $50 Billion

- **Establishment and Responsibilities of Risk Committee.** As with similarly sized FBOs, a publicly traded BHC with total consolidated assets of $10 billion or more (but less than $50 billion) is required to establish and maintain a risk committee that approves and periodically reviews the risk-management policies of its global operations and oversees the operation of its global risk management framework. Total consolidated assets for purposes of the risk management requirement are calculated as the average of the total assets for the four most recent quarters as reported on the BHC's FR Y-9C. The BHC's risk management framework must be commensurate with its capital structure, risk profile, complexity, activities, and size must include enumerated policies, procedures, processes, and systems.
- **Risk Committee Member Requirements.** The risk committee must include at least one member with relevant risk management expertise which can be gained from prior experience working for a large, complex bank or for a large, complex nonbanking or nonfinancial firm. The committee must be chaired by an independent director.[18] All committee members must have an understanding of risk management principles and practices relevant to the BHC.
- **Corporate Governance.** The risk committee must have a formal, written charter that is approved by the BHC's board of directors, and must meet quarterly (and otherwise as needed) and fully document and maintain records of its proceedings.
- **Timing of Compliance.** In general, a BHC subject to this section must comply with its requirements beginning on the first day of the ninth quarter either on the date its total consolidated assets are at least $10 billion, or on the date on which any class of stock becomes publicly traded, whichever is later. An FBO may cease compliance with this section if its total consolidated assets fall below $10 billion for four consecutive calendar quarters, if its total consolidated assets are at least $50 billion and it becomes subject to the requirements at that level, or if it ceases to be a publicly traded BHC.

Liquidity Requirements

The Final Rule implements a set of specific liquidity requirements for US BHCs and FBOs that have at least $50 billion in total

consolidated assets. Aside from a handful of changes, the liquidity requirements were adopted generally as proposed for both FBOs and BHCs. The liquidity requirements for FBOs that have less than $50 billion in combined US assets (including US Branches and either IHCs or US subsidiaries) are significantly more limited than those for FBOs that have more than $50 billion in combined US assets. Although in many cases the liquidity requirements continue to allow a company the flexibility to take into account its specific circumstances (capital structure, risk profile, complexity, activities, and size), the prescriptive nature of the specific requirements results in a substantial and complex new liquidity regime for FBOs with at least $50 billion in combined US assets. Under the Final Rule, US BHCs with at least $50 billion in total consolidated assets are also subject to a very similar liquidity regime, although those BHCs were already subject to several existing or separately proposed liquidity requirements.

FOREIGN BANKING ORGANIZATIONS

FBOs with Combined US Assets of $50 Billion or More

FBOs with combined US assets of at least $50 billion face an extensive set of new US-centric liquidity risk management and liquidity stress testing and buffer requirements in the Final Rule. The liquidity risk management framework for these FBOs includes (i) specific liquidity risk management obligations for the US risk committee and chief risk officer, (ii) an independent review function, (iii) internal cash flow projections, (iv) a contingency funding plan, (v) liquidity risk limits, and (vi) liquidity risk monitoring. Liquidity stress tests for US operations must be conducted monthly taking into account the characteristics of the FBO's operations and a range of stress scenarios. Separate liquidity buffers are required for an FBO's IHC and its US Branches, based on the results of the liquidity stress tests. The Final Rule does not impose liquidity requirements on the FBO as a whole, other than requiring FBOs to make available to the FRB the results of any liquidity internal stress tests and information about liquidity buffers required by home country regulators. These requirements are discussed in more detail below.

Framework for Managing Liquidity Risk. The Final Rule splits certain responsibilities for managing liquidity risk between the US risk committee (or a designated subcommittee of the risk committee) and the US chief risk officer of the FBO. The US risk committee (or designated subcommittee) must (i) approve the liquidity risk tolerance of the US operations at least annually, (ii) review information from management at least semi-annually to determine whether the US operations are operating in accordance with the established liquidity risk tolerance, (iii) approve the contingency funding plan at least annually, and (iv) review significant business lines and products to evaluate liquidity risk. The US chief risk officer has a longer list of responsibilities, including (i) reviewing strategies and policies and procedures for managing liquidity risk, (ii) determining whether the US operations are operating in accordance with the established liquidity risk tolerance and reporting that to the US and enterprise-wide risk committees, (iii) reviewing and approving each new business line and product offered through the FBO's US operations that could have a material impact on the liquidity of those operations, (iv) reviewing cash-flow projections at least quarterly, (v) establishing liquidity risk limits and monitoring compliance with those limits at least quarterly, and (vi) approving liquidity stress testing methodologies and assumptions, reviewing the results of liquidity stress testing, and approving the size and composition of the required liquidity buffer, all at least on a quarterly basis. The specific requirements imposed by the Final Rule for many of these responsibilities are discussed further below. In addition, an FBO with combined US assets of at

least $50 billion is required to establish an independent review function to evaluate, on at least an annual basis, the liquidity risk management for its combined US operations.

- **Comprehensive Cash-Flow Projections.** The Final Rule requires each FBO to produce and frequently update comprehensive cash-flow projections for its combined US operations over short- and long-term time horizons. The methodology used to produce the cash-flow projections must meet certain specified guidelines.
- **Contingency Funding Plan.** An FBO must establish, maintain, and update at least annually a contingency funding plan for its combined US operations that addresses liquidity needs during liquidity stress events.[19] The contingency funding plan must identify and assess potential liquidity stress events and the manner in which the FBO would respond, including what funding sources and alternative funding sources the FBO would seek to use in such circumstances. The Final Rule requires that the contingency funding plan include an event management process that describes the procedures the FBO will use for maintaining liquidity during identified liquidity stress events, including (i) an action plan for responding to liquidity shortfalls, (ii) a liquidity stress event management team, (iii) the triggers for invoking the contingency funding plan and other decisions, and (iv) the measures for reporting and communication within the FBO and with outside parties. In addition, the contingency funding plan must include procedures for monitoring emerging liquidity stress events. An FBO required to maintain a contingency funding plan must periodically test certain elements of the plan and methods the FBO intends to use for accessing alternative funding sources when needed.
- **Liquidity Risk Limits.** The required liquidity risk limits must include limits on (i) concentrations in sources of funding by instrument type, single counterparty, counterparty type, secured and unsecured funding, and other forms of liquidity risk, (ii) the amount of liabilities that mature within various time horizons, and (iii) off-balance sheet and other exposures. The limits must be consistent with the established liquidity risk tolerance for the combined US operations of the FBO.
- **Risk Monitoring Requirements.** An FBO must establish and maintain procedures for monitoring liquidity risk with respect to (i) collateral both within and across legal entities, currencies, and business lines and (ii) intraday exposures, subject to specified guidelines.
- **Liquidity Stress Testing.** The Final Rule requires an FBO to conduct stress tests at least monthly to assess the potential impact of liquidity stress scenarios on the cash flows, liquidity position, profitability, and solvency of the FBO's (i) combined US operations as a whole, (ii) US Branches, and (iii) IHC. Each liquidity stress test must, at a minimum, cover three scenarios reflecting adverse market conditions, an idiosyncratic stress event for the US Branches and IHC, and combined market and idiosyncratic stresses. Each liquidity stress test must also include planning horizons that extend overnight, 30 days, 90 days, and one year. The Final Rule also imposes other assumptions and requirements with respect to the content of the liquidity stress tests, such as discounts in the fair value of assets to reflect credit risk and diversification of cash-flow sources, as well as certain governance requirements regarding the liquidity stress testing process. The FRB generally expects that any liquid assets and cash-flow sources considered for purposes of the stress tests will be in the same location and legal entity as the outflows. Finally, FBOs generally must make available to the FRB, on a timely basis, the results of any internal

liquidity stress tests and liquidity buffers required by home country regulators.

- **Liquidity Buffer.** The Final Rule requires an FBO to maintain in the United States separate liquidity buffers for its IHC and its US Branches. The liquidity buffer for the IHC must be sufficient to meet the projected "net stressed cash-flow need" over the 30-day planning horizon of the liquidity stress tests, taking into account the various scenarios required for those liquidity stress tests. The liquidity buffer for the US Branches must be sufficient to meet the projected net stressed cash-flow need over only the first 14 days of the 30-day planning horizon. The 14-day requirement for the US Branches represents a change from the FBO Proposal, which would have required the US Branches to maintain the liquidity buffer for the entire 30 days, although the portion beyond 14 days could have been maintained outside the United States. Under the Final Rule, the assets comprising the liquidity buffer for both the IHC and the US Branches must be held in the United States (i.e., reflected on their respective balance sheets). In addition, the cash component of the IHC's liquidity buffer may not be held in an account at an affiliate of the IHC (including a US branch or agency of the FBO), except that an IHC may hold cash at a subsidiary of the IHC. Similarly, the cash component of the US Branches' liquidity buffer may not be held in an account at an affiliate of the US Branches (including the IHC and its subsidiaries). The formula for calculating the net stressed cash-flow need is complex and, despite significant criticism from the industry, remains essentially unchanged from the FBO Proposal. Accordingly, the Final Rule retains the prohibition on netting of internal and external cash-flows, thus restricting the ability of the US operations of an FBO to rely on intra-group cash flows to meet external cash-flow needs.
  - **Composition of Liquidity Buffer.** Each liquidity buffer must consist only of highly liquid assets that are unencumbered. Highly liquid assets specifically include cash, and securities issued or guaranteed by the US government (including its agencies and US government-sponsored enterprises). They also include any other asset that the FBO demonstrates to the satisfaction of the FRB (i) has low credit and market risk, (ii) is traded in an active secondary two-way market, and (iii) is a type of asset that investors historically have purchased in periods of financial market distress during which market liquidity has been impaired. The FRB noted in the preamble to the Final Rule that high-quality liquid assets under the proposed US liquidity coverage ratio (LCR) (discussed below) would generally qualify as highly liquid assets under most scenarios. An asset is unencumbered if it is free of legal, regulatory, contractual, and other restrictions on the ability to liquidate or sell the asset, and is either not pledged to secure credit enhancement to any transaction or is pledged to a central bank or US-government sponsored enterprise to the extent credit secured by the pledge is not currently being extended. The Final Rule makes clear that assets pledged by a US Branch pursuant to the OCC's "capital equivalency deposit" requirement or a state-imposed asset pledge requirement cannot be used for liquidity buffer purposes. The composition of each liquidity buffer is also subject to certain valuation and diversification requirements under the Final Rule.
- **Relationship to Basel III Liquidity Coverage Ratio.** In response to comments concerning the relationship and potential overlap between the two, the FRB emphasized that the liquidity buffer and related liquidity requirements in the Final Rule are intended to complement the Basel III "Liquidity Coverage

Ratio."[20] The liquidity stress tests and buffer requirements of the Final Rule are intended to provide an individualized view of a firm under multiple scenarios, including assumptions adopted by the company in light of its specific products and risk profile. By contrast, the Basel III LCR framework and US LCR proposal are designed to provide a standardized measure of liquidity adequacy under specified and detailed supervisory assumptions regarding factors such as cash outflows and inflows, thereby facilitating transparency across companies. The FRB views both as key components of robust liquidity risk management practices. The FRB also noted that it intends through future rulemakings to apply the US LCR standards to the US operations of "some or all" FBOs with at least $50 billion in combined US assets.

FBOs with Combined US Assets of Less than $50 Billion

FBOs that have total consolidated assets of at least $50 billion, but combined US assets of under $50 billion, are subject only to very limited liquidity requirements under the Final Rule, which adopted this aspect of the FRB Proposal without material change. They must report to the FRB on an annual basis the results of an internal company-run liquidity stress test for either the consolidated operations of the FBO as a whole, or the combined US operations of the FBO. This liquidity stress test must be consistent with the BCBS principles for liquidity risk management and must incorporate 30-day, 90-day, and one-year time horizons. Notably, and unlike the parent FBO stress testing requirement for FBOs with combined US assets of at least $50 billion discussed above, this stress testing requirement appears to apply whether or not the FBO's home country regulator actually imposes such a requirement. If an FBO with combined US assets of less than $50 billion fails to comply with the liquidity stress test requirement results, then it must limit the net aggregate amount owed by the FBO's non-US offices and its non-US affiliates to the combined US operations to 25 percent or less of the third-party liabilities of its combined US operations on a daily basis.

US BANK HOLDING COMPANIES

US BHCs with Assets of $50 Billion or More

US BHCs with total consolidated assets of at least $50 billion are subject to a set of liquidity requirements that is substantially the same as for FBOs with combined US assets of at least $50 billion. One key difference, of course, is that the requirements for BHCs apply to the BHC, whereas the requirements for FBOs that have combined US assets of at least $50 billion generally apply only to the US operations of the FBO. Because of the substantial similarity of the two regimes, this section highlights only those key aspects of the requirements for BHCs that significantly differ from those for large FBOs.

- **Framework for Managing Liquidity Risk.** Unlike the responsibilities for FBOs, which are divided between the US risk committee and the US chief risk officer, the requirements for BHCs are allocated among the board of directors, the risk committee (or a designated subcommittee), and senior management. The BHC's board of directors must (i) approve the liquidity risk tolerance of the BHC at least annually, (ii) review information from management at least semiannually to determine whether the BHC is operating in accordance with the established liquidity risk tolerance, and (iii) approve the liquidity risk management strategies, policies, and procedures established by senior management. The risk committee (or a designated subcommittee) must approve the BHC's contingency funding plan at least annually. Senior management is responsible for the remaining liquidity risk management responsibilities, including (i) establishing strategies, policies, and procedures to manage liquidity risk, (ii) developing and implementing

measurement and reporting systems, (iii) determining at least quarterly whether the BHC is operating in accordance with its policies and procedures and is otherwise in compliance with its liquidity risk management requirements, (iv) reporting to the board of directors or risk committee concerning liquidity risk profile and tolerance, (v) reviewing and approving each new business line and product that could have a material impact on liquidity and reviewing them to determine whether there are any unanticipated liquidity risks, (vi) reviewing the required cash-flow projections, (vii) establishing liquidity risk limits and reviewing compliance with those limits, and (viii) approving the required liquidity stress testing practices, reviewing the results, and approving the size and composition of the liquidity buffer, all on at least a quarterly basis. In response to comments, the Final Rule does shift some responsibilities from the board of directors and the risk committee to senior management in recognition of the fact that the board of directors and the risk committee should have more of an oversight and monitoring role.

- **Liquidity Buffer.** BHCs with total consolidated assets of at least $50 billion are required to establish a liquidity buffer that, like the liquidity buffers required for FBOs with combined US assets of at least $50 billion, is comprised of similar assets and is sufficient to meet the projected net stressed cash-flow need over the same 30-day planning horizon and scenarios. However, unlike the separate liquidity buffers required for an FBO's IHC and its US Branches, there is only one consolidated liquidity buffer for a BHC. Moreover, the restrictions on netting internal and external cash-flow requirements for FBOs do not apply to BHCs under the Final Rule since the buffer is established on a consolidated basis.

Capital Stress Test Requirements

Section 165(i)(1) of the Dodd-Frank Act requires the FRB to conduct annual stress tests of US BHCs with total consolidated assets of $50 billion or more, including those owned by FBOs. In addition, section 165(i)(2) of the Dodd-Frank Act requires the FRB to issue rules that require certain regulated financial companies, including FBOs and foreign savings and loan holding companies (FSLHCs) with total consolidated assets of more than $10 billion, to conduct company-run stress tests.

The FRB has already issued final rules regarding stress testing of large US BHCs and already conducts supervisory stress tests under those rules. For example, in November 2011, the FRB issued the CCAR rules, the operation of which is informed by supervisory stress test results. In October 2012, the FRB issued rules implementing supervisory and company-run stress testing requirements for a larger group of US BHCs.[21] Finally, in November 2013, the FRB issued its annual instructions for the 2014 CCAR program applicable to BHCs with $50 billion or more of total consolidated assets and the annual scenarios for the stress tests required of BHCs, savings and loan holding companies (SLHCs), and state member banks with $10 billion or more of total consolidated assets.[22]

The Final Rule generally adopted the Domestic Proposal and FBO Proposal requirements without significant modification.

FOREIGN BANKING ORGANIZATIONS

The FBO Proposal sought to adapt for FBOs the requirements of stress testing rules already applicable to US BHCs. The Final Rule generally adopts the FBO Proposal without significant modifications. The stress test cycle will begin (i) in October 2015 for US BHC subsidiaries of FBOs that currently rely upon Supervision and Regulation Letter SR 01-01; (ii) in July 1, 2016 for FBOs with total consolidated assets of more than $10 billion but less than $50 billion; and (iii) in October 2017 for IHCs.

Stress Tests for FBOs with Combined US Assets of $50 Billion or More

- **Home-Country Stress Testing.** An FBO with combined US assets of $50 billion or more that has a US Branch must provide the FRB with information about its home-country consolidated capital stress testing activities and results by January 5 of each year. The home-country stress testing regime must include either (i) an annual supervisory capital stress test conducted by the FBO's home-country supervisor or (ii) an annual evaluation and review by the FBO's home-country supervisor of an internal capital adequacy stress test conducted by the FBO. The information the FBO is required to submit to the FRB includes: (i) a description of the types of risks included in the stress test; (ii) a description of the conditions or scenarios used in the stress test; (iii) a summary description of the methodologies used in the stress test; (iv) estimates of the FBO's projected financial and capital condition; and (v) an explanation of the most significant causes for the changes in regulatory capital ratios as shown in the stress test.

  Significantly, if the US Branches are in a net due from position to the FBO, calculated as the average daily position from a given October-to- October period, the FBO would be required to report additional information to the FRB on its stress tests, including: (i) a detailed description of the methodologies used in the stress test; (ii) detailed information regarding the organization's projected financial and capital position over the planning horizon; and (iii) any additional information the FRB requests.

- **Failure to Comply.** In the event the FBO fails to comply with the stress test requirements listed above, the FBO's US Branches must meet a 108 percent asset maintenance requirement. If the FBO has not established an IHC, it would be required to conduct an annual stress test of its US subsidiaries, either separately or as part of an FRB approved enterprise-wide stress test, to determine whether they have capital necessary to absorb losses as a result of adverse economic conditions, and to report summary information about the results to the FRB on an annual basis. In addition, the FRB may impose intra-group funding restrictions on the US operations of the FBO or may impose increased local liquidity requirements.

Stress Tests for FBOs with Total Consolidated Assets of $50 Billion or More and Combined US Assets of Less than $50 Billion and FBOs and FSLHCs with Total Consolidated Assets over $10 Billion, but Less than $50 Billion

- **Home-Country Stress Testing.** An FBO and an FSLHC with total consolidated assets of more than $10 billion must be subject to a consolidated capital stress testing regime that includes either (i) an annual supervisory capital stress test conducted by the FBO's home-country supervisor or (ii) an annual evaluation and review by the FBO's home-country supervisor of an internal capital adequacy stress test conducted by the FBO. Such an FBO is not subject to separate information requirements imposed by the FRB relating to the results of stress tests.
- **Failure to Comply.** Failure to meet this requirement will result in the FRB requiring the FBO's US Branches to meet a 105 percent asset maintenance requirement (lower than the 108 percent requirement above due to the more limited risk this category of FBO poses to the US economy) and the FBO to (i) conduct an annual stress test of its US subsidiaries, either separately or as part of an enterprise-wide stress test, to determine whether they have the capital necessary to absorb the results of adverse economic conditions and (ii) submit a report on the test to the FRB on an annual basis.

US BANK HOLDING COMPANIES

The Domestic Proposal sought to incorporate the FRB's existing standards for capital planning and stress testing that were issued in 2011 and 2012. The Final Rule generally adopts the Domestic Proposal. The stress testing requirements applicable to US BHCs with $50 billion or more in consolidated assets also apply to IHCs.[23]

Supervisory Stress Tests for US BHCs with Total Consolidated Assets of $50 Billion or More and Nonbank Financial Companies Supervised by the FRB

- **Covered Companies.** A US BHC, including a subsidiary of an FBO, with average total consolidated assets of $50 billion or more (calculated from the four most recent FR Y-9C filings) or a nonbank financial company supervised by the FRB (collectively, a "covered company") is subject to supervisory capital stress testing by the FRB that evaluates the ability of the covered company to absorb losses in specified economic and financial conditions.
- **Submission of Information in Response to FRB Scenarios.** The FRB will notify covered companies of its planned scenarios (at least three) no later than November 15 of each year, except for trading and other components, which will be communicated by December 1. The covered company is required to submit the information needed by the FRB to conduct its analysis, and this information is covered by the FRB's confidential supervisory information regulations.
- **Summary of Results.** By March 31, the FRB will communicate a summary of the results to the covered company and publicly disclose that summary. The covered company is required to use the results of the stress testing in (i) its capital plan and capital planning process; (ii) assessing its exposures, concentrations, and risk positions; and (iii) its update to its resolution plan.

Company-Run Stress Tests for US BHCs with Total Consolidated Assets of $50 Billion or More and Nonbank Financial Companies Supervised by the FRB

- **Annual Stress Test.** A US BHC, including a subsidiary of an FBO, with average total consolidated assets of $50 billion or more (calculated from the four most recent FR Y-9C filings) or a nonbank financial company supervised by the FRB (collectively, a "covered company") is required to conduct an annual stress test by January 5 based on data as of September 30 of the preceding calendar year using scenarios provided by the FRB. The FRB will provide the scenarios no later than November 15, except for a trading and counterparty activity component or other component, which will be provided by December 1.
- **Mid-Cycle Stress Test.** In addition to the annual stress test, a covered company must conduct a mid-cycle stress test by July 5 based on data as of March 31 of that calendar year using its own scenarios. A covered company's scenarios must include a minimum of three scenarios: a baseline scenario, an adverse scenario, and a severely adverse scenario.
- **Reporting Stress Test Results.** The covered company must report the results of the annual company-run stress test to the FRB by January 5 and the results of the mid-cycle stress test by July 5. The covered company's report to the FRB is covered by the FRB's confidential supervisory information regulations, but the covered company is required to disclose summaries of the annual and mid-cycle stress tests between March 15 and March 31 and September 15 and September 30, respectively.
- **Use of Stress Test Results.** The board of directors and senior management must use the results of the stress tests in (i) their capital plan and capital planning process; (ii) assessing their exposures, concentrations, and risk

positions; and (iii) their update to the covered company's resolution plan.

Company-Run Stress Tests for US BHCs, US SLHCs, and State Member Banks with Total Consolidated Assets Over $10 Billion and Less than $50 Billion

- **Annual Stress Test.** US BHCs or US SLHCs or state member banks with total consolidated assets of greater than $10 billion, as measured by the four most recent FR Y-9C filings or Call Reports are required to conduct annual stress tests. For US SLHCs with total consolidated assets of $50 billion or more and state member banks that are subsidiaries of covered companies (defined above), the stress test must be conducted and reported to the FRB by January 5 using data as of September 30 of the preceding year. For US BHCs and US SLHCs and state member banks that are not subsidiaries of covered companies, the stress test must be conducted and reported to the FRB by March 31 using data as of September 30 of the preceding year. The FRB will notify the US BHCs, US SLHCs, and state member banks of its planned scenarios no later than November 15 of each year, except for trading and other components, which will be communicated by December 1.
- **Reporting Stress Test Results.** The report by the US BHC, US SLHC, or state member bank to the FRB is covered by the FRB's confidential supervisory information regulations, but the US BHC, US SLHC, or state member bank is required to disclose a summary of the stress test between June 15 and June 30 or March 15 and March 31, depending on its classification. The disclosures will be required for stress tests conducted during the cycle beginning October 1, 2014. A state member bank that is a subsidiary of a BHC may satisfy its disclosure obligation through its parent's disclosure, unless the FRB determines the BHC's disclosures do not adequately capture the potential impact of the scenarios on the capital of the state member bank.
- **Use of Stress Test Results.** The board of directors and senior management must consider the results of the stress tests in their normal course of business, including (i) capital planning; (ii) capital adequacy assessments; and (iii) risk management practices.

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Endnotes

[1] The Final Rule, which is currently only available in draft form, is available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140218a1.pdf. The Final

Rule has not yet been published in the Federal Register. The Final Rule generally does not apply to US and foreign savings and loan holding companies, but the Final Rule does impose stress test requirements on such companies, as discussed in more detail below.

[2] The Mayer Brown Legal Update about the FBO Proposal is available at http://www.mayerbrown.com/files/Publication/c49271f3-cab0-4119-a561-e8b5cc1c8377/Presentation/PublicationAttachment/bff31254-7fe5-4784-b666-b0364bf4a79c/UPDATE-FSRE_Prudential%20Standards%20NonUS%20Bank_1212_V2.pdf.

[3] The BCBS "large exposure" proposal is available at http://www.bis.org/publ/bcbs246.pdf.

[4] *See, e.g.,* Jim Puzzanghera, *European Regulator Concerned about New Fed Rules for Foreign Banks*, L.A. TIMES, Feb. 19, 2014, available at http://www.latimes.com/business/money/la-fi-mo-federal-reserve-europe-foreign-bank-rule-20140219,0,1479375.story#axzz2uMxIqTlF; *see also* Jim Brunsden, *US Foreign Bank Rule Risks Fragmenting Markets, Barnier Says*, BLOOMBERG, Feb. 20, 2014, available at http://www.bloomberg.com/news/2014-02-20/u-s-foreign-bank-rule-risks-fragmenting-markets-barnier-says.html.

[5] For instance, Deutsche Bank recently announced that it will reduce its US operations by $100 billion in response to the Final Rule. *See, e.g., Deutsche Bank to Slash US-based Assets by $100 Billion: FT*, REUTERS, Feb. 23, 2014, available at http://www.reuters.com/article/2014/02/23/us-fed-banks-deutsche-idUSBREA1M15Q20140223.

[6] Preamble at 150.

[7] Section 2(h)(2) of the BHCA allows certain FBOs to hold interests in certain non-US nonfinancial companies that are principally engaged in business outside the United States, even when those firms conduct business in the United States, assuming certain conditions are met.

[8] 12 USC 1841(a)(2).

[9] Preamble at 150.

[10] "US Basel III" refers to the revised US capital framework adopted in July 2013, which incorporated not only the BCBS Basel III framework, but also elements of Basel II that had not previously been adopted in the United States and certain amendments to the US regulatory capital framework required by the Dodd-Frank Act. 78 Fed. Reg. 62018 (Oct. 11, 2013).

[11] All eligible IHCs are permitted to use the US advanced approaches rules if they choose to do so, either by "opting in" to the advanced approaches regime or, in the case of an IHC that is a BHC, by declining to seek FRB approval not to comply with those requirements.

[12] 12 C.F.R. 217.61.

[13] BCBS, "Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement" (July 2013), available at: http://www.bis.org/publ/bcbs255.pdf.

[14] Capital Plans, 76 Fed. Reg. 74631 (Dec. 1, 2011), available at http://www.gpo.gov/fdsys/pkg/FR-2011-12-01/pdf/2011-30665.pdf; Supervisory and Company-Run Stress Test Requirements for Covered Companies, 77 Fed. Reg. 62378 (Oct. 12, 2012), available at http://www.gpo.gov/fdsys/pkg/FR-2012-10-12/pdf/2012-24987.pdf.

[15] For FBOs with combined US assets of $50 billion or more, an independent member is a member who (i) is not an officer or employee of the company or its affiliates and has not been an officer or employee of the company or its affiliates during the previous three years; and (ii) is not a member of the immediate family of a person who is, or has been within the last three years, an executive officer of the company or its affiliates.

[16] We note that, in the text of the Final Rule as currently drafted, this notification process only applies to FBOs with total consolidated assets of at least $50 billion but with less than $50 billion in combined US assets and to publicly traded FBOs with at least $10 billion in total consolidated assets, but not to FBOs with US assets of $50 billion or more. No justification for this different treatment is given, and it may be an oversight that will be corrected when the Final Rule is published in the Federal Register.

[17] An FBO is a "publicly traded company" if any class of stock (or similar interest, such as an American Depositary Receipt) is publicly traded.

[18] The Final Rule clarifies that an independent director for a BHC is one who (i) is not an officer or employee of the BHC and has not been an officer or employee of the BHC during the previous three years; (ii) is not a member of the immediate family, as defined in Regulation Y, of a person who is, or has been within the last three years, an executive officer of the bank holding company, as defined in Regulation O; and (iii)(A) is an independent director under the US Securities and Exchange Commission's ("SEC") Regulation S-K, if the BHC has an outstanding class of securities traded on an exchange registered with the SEC as a national securities exchange; or (B) would qualify as an independent director under the listing standards of a national securities exchange, as demonstrated to the satisfaction of the FRB, if the BHC does not have an outstanding class of securities traded on a national securities exchange.

[19] The Final Rule is limited to the US operations of FBOs and does not purport, for example, to cover the FBO's global US dollar funding needs.

[20] Information about the BCBS's Basel III LCR is available at http://www.bis.org/publ/bcbs238.htm. In October 2013, the FRB, together with the other federal banking regulators, proposed a US LCR based on the Basel III LCR. The proposed US LCR would apply to all internationally active banking organizations, generally, bank holding companies, certain savings and loan holding companies, and depository institutions with more than $250 billion in total assets or more than $10 billion in on-balance sheet foreign exposure, and to their consolidated subsidiaries that are depository institutions with $10 billion or more in total consolidated assets. A modified version of the US LCR would be applied to BHCs and certain savings and loan holding companies with $50 billion or more in consolidated assets. A copy of the US LCR proposal is available at http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf. The Mayer Brown Legal Update about the US LCR proposal is available at http://www.mayerbrown.com/The-US-Federal-Reserve-Board-Proposes-a-Liquidity-Coverage-Ratio-For-Large-Banking-Organizations-and-Systemically-Important-Non-Banks-10-30-2013/.

[21] 77 Fed. Reg. 62378 (Oct. 12, 2012) (supervisory and company-run stress testing requirements for BHCs with total consolidated assets of $50 billion or more and nonbank financial companies supervised by the FRB); 77 Fed. Reg. 62396 (Oct. 12, 2012) (company-run stress test for BHCs with consolidated assets of more than $10 billion but less than $50 billion).

[22] Comprehensive Capital Analysis and Review 2014 Summary Instructions and Guidance (Nov. 1, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131101a2.pdf; 2014 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule (Nov. 1, 2013), *available at* http://www.federalreserve.gov/bankinforeg/bcreg20131101a1.pdf. For the 2013-2014 cycle, the CCAR program covers 30 BHCs, while approximately 60 additional BHCs, SLHCs, and state member banks are expected to be subject to non-CCAR company-run stress testing under DFAST. No FBOs are subject to DFAST for the 2013-2014 cycle; existing IHCs (i.e., US domiciled BHCs that are subsidiaries of FBOs and are currently relying on Supervision and Regulation Letter 01-01 issued by the FRB) will not be subject to DFAST until the 2015-2016 cycle.

[23] 12 C.F.R. § 252.153(e)(5).

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Table 1

Scope of Application for FBOs

GLOBAL ASSETS	US ASSETS	SUMMARY OF REQUIREMENTS THAT APPLY TO FBOS
> $10 billion and < $50 billion	n/a	• Meet home-country annual capital stress test requirements or comply with a 105% asset maintenance requirement for US branches and agencies and conduct annual stress test of US subsidiaries • If publicly traded, have a risk committee of its global board with responsibility for risk management of US operations (can be part of an enterprise-wide risk committee) and with at least one member with risk management expertise, or face discretionary restrictions on US activities/operations
> $50 billion	< $50 billion	All of the above (including US risk committee requirement), plus: • Meet home-country capital standards, including any minimum leverage ratio and all restrictions based on any applicable capital buffers, that are consistent with global Basel III standards (including transition periods), or face discretionary restrictions on US activities/operations • Subject to an annual company-run liquidity stress test requirement consistent with BCBS principles for either the consolidated FBO or the combined US operations ("noncompliance" results in a cap on funding to head office and affiliates of 25% of third-party liabilities)
> $50 billion	> $50 billion	All of the above, plus: • Subject to US intermediate holding company (IHC) requirements if non-branch US assets of at least $50 billion – All US IHCs are subject to US BHC capital requirements, including any US supplementary leverage buffer and potential G-SIB surcharges (if applicable, based on size) – All US IHCs are subject to capital planning (CCAR) and capital and liquidity stress testing requirements to the same extent as large US BHCs, which include annual supervisory stress tests and mid-cycle company-run stress tests – All US IHCs must maintain their own risk committee (which can also serve as the overall US risk committee for the FBO) that oversees a formal risk-management framework • Have a local US chief risk officer, in addition to the US risk committee (which must have at least one independent member), and which together oversee and implement the risk management framework and policies and procedures for the US operations, including for liquidity risk management • Comply with extensive liquidity risk management obligations with respect to its US operations, including liquidity risk tolerance, liquidity risk limits, monthly company-run liquidity stress tests, contingency funding planning, and liquidity buffers (30 days for IHC; 14 days for US branches and agencies) • Report to the FRB the results of the annual home-country capital stress testing ("noncompliance" results in a 108% asset maintenance requirement for US branches and agencies and, if no IHC, requirement to conduct annual stress test of US subsidiaries and possible intra-group funding restrictions) and home-country liquidity stress testing (if any)

Table 2:

Scope of Application for BHCs

TOTAL ASSETS	SUMMARY OF REQUIREMENTS THAT APPLY TO BHCS
> $10 billion and < $50 billion	• Perform annual company-run capital stress tests, the results of which must be reported to the FRB and a summary of which must be publicly disclosed • If publicly traded, have a risk committee approved by the board of directors that (i) approves and periodically reviews the risk-management policies of the BHC's global operations and (ii) oversees the operation of the BHC's global risk-management framework
> $50 billion	The above, including the risk committee requirements, plus: • Comply with risk-based and leverage capital regulations and previously adopted capital planning (CCAR) and stress test requirements, which include annual supervisory stress tests and mid-cycle company-run stress tests • Comply with extensive liquidity risk management obligations, including liquidity risk tolerance, liquidity risk limits, monthly company-run liquidity stress tests, and liquidity stress event contingency funding planning • Maintain a 30-day liquidity buffer of highly liquid assets sufficient to meet net stressed cash-flow needs, as determined through the monthly company-run liquidity stress tests • Include liquidity risk management within the risk committee's responsibilities and designate the risk committee as a committee of the board of directors • Have a chief risk officer, in addition to the risk committee (which must have at least one independent member), and which together with the board of directors and senior management, approve, oversee, and implement the risk management framework and policies and procedures for the BHC, including for liquidity risk management